The Real Debt Danger

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Ignore the noise about government debt, it's the borrowing of individuals and households that should have us really worried - especially as the mining boom fades, writes Ian McAuley

Australia has a debt problem, but it's not about government debt.

First, the facts about government debt. When Kevin Rudd came to office in 2007 the Commonwealth had net financial assets of four per cent of GDP, and when Labor lost office in 2013 the Commonwealth had net debt of thirteen per cent of GDP. In its first budget the Rudd Government actually planned to run significant surpluses during its first term, but these plans were derailed by the Global Financial Crisis (GFC), which took on full force in late 2008. As any responsible government would have done, in order to sustain economic activity it rapidly switched to running stimulatory deficit budgets, thereby managing to get through the crisis without a recession.

Any government, "left" or "right", would have pursued the same general path. Economists differ on specific points to do with timing and the nature of the stimulus payments, but not on the need for incurring modest deficits.

The Commonwealth's financial liabilities (aka "gross debt") are now around $400 billion, or 23 per cent of GDP, but offsetting these liabilities are financial assets of around $170 billion, leaving net financial liabilities (aka "net debt") of around $230 billion, or 13 per cent of GDP. (These figures are taken from Statement 7 of Budget Paper 1, but are rounded, because there are many assumptions in valuing liabilities such as public service superannuation and assets such as HECS repayments.)

In a historical context this is low — Australia's peak Commonwealth debt was around 130 per cent of GDP just after the Pacific War, and it has been on a downward trend ever since. And in an international context Australia is in the small league: the average net debt for OECD countries is 70 per cent of GDP.

You won't find these figures in the budget statements or in anything coming out of Abbott's or Hockey's offices.

To gain any meaningful insight we have to look beyond these aggregate figures, because there are some important qualifications.

First, they are only about central government debt, an important issue in a federation such as Australia. State governments borrow money too, and that adds around another 6 per cent to our net government debt. Again these figures are subject to interpretation, particularly the treatment of debt in government business enterprises (GBEs) such as water utilities, and apportionment of liabilities in public-private partnerships. But whatever assumptions we use, Australia is not carrying high government debt.

Second, any discussion about debt is meaningless unless it is accompanied by consideration of the uses of that debt. Domestically, there is a heap of difference between the mortgage you take to finance your house and the credit card debt you run up to finance your taste in expensive dining or slow horses. So too with governments.

At one extreme is Greece, which used borrowing as an alternative to taxes, in order to maintain a generous social welfare system. A little to the north is Germany, with debt at 48 per cent of GDP, which has been used to fund high quality infrastructure and reconstruction of its eastern states. We need to look at the asset side of the public balance sheet, not just the debt side.

Just as investors would look down on a public company which did not include debt in its financing mix, so too would it be a loss of opportunity for a government with a good credit rating (as the Commonwealth and most states enjoy) not to use debt to finance productive assets. Our public debt obsession, however, has taken us down the path of resorting to privatisations and public-private partnerships, which are generally expensive ways to finance infrastructure. Whether we finance these assets through private or public sources, we still have to repay the debt, and generally governments can borrow more cheaply than the private sector.

Third, as the Age's economics editor Peter Martin reminded us on a recent Life Matters show we should remember that governments, like companies, are ongoing entities. So long as the government exists, its debt does not have to be repaid. It has to be serviced, but not repaid. If we look at the historical balance sheets of successful companies we see that their debt generally expands as their turnover and asset base expands. That's quite unlike our domestic situation, where most people reasonably strive to reduce debt as they age.

Fourth, government is only one entity in the economy, and debt should be seen in its aggregate context, particularly in our borrowing from and lending to the rest of the world. If we could look on debt in this broader context we would realise that many of the Commonwealth's budget measures simply shuffle debt around. We would then see that its higher education changes transfers debt from the government (and therefore borne by the whole community) to students.

Spain, for example, got into strife because while it had low government debt prior to the GFC, a speculative building boom had fuelled high private debt, much of it owed to foreigners, and the government had take on a large part of that liability. Japan provides an example in the other direction. Its government debt is about 140 per cent of GDP, but it's all held domestically by Japanese households and businesses. In fact internationally Japan is in credit, while countries like Australia and the USA are in debt to the rest of the world, and are getting deeper into debt.

Over the last 25 years Australia's net foreign debt has risen from around 30 to 55 per cent of GDP. Much of this is debt incurred for housing, both for owner-occupiers and (increasingly) for investors — not that you or I go to foreign markets to arrange our mortgages, but the banks from which we borrow do.

If we were on the verge of a sustained upturn in economic growth, then increasing foreign debt may not matter. But the investment phase of our resource boom is over, iron ore prices are falling, and steaming coal is in a price decline from which it will probably never recover. There will be some expansion of gas production, but much of the benefit will pass to foreign investors.

Foreigners have been lending to Australia because of our relatively high interest rates and AAA government credit rating. (If only Labor really had screwed up its fiscal management we would not be in such a boom-bust situation!) When global interest rates rise, as they will one day, and lenders realise that they have been funding housing price inflation, money will slosh right out as easily as it has sloshed in. Then we will face a real debt crisis.

The Commonwealth, either through ignorance or a desire to generate a false sense of confidence, is oblivious to the risks associated with foreign debt and asset price inflation. In Budget Paper 1 is the extraordinary statement "The increase in dwelling prices since mid-2013 has coincided with higher equity prices and generated an 11 per cent rise in household wealth". This confusion of asset price inflation with real wealth is exactly the thinking that led the world to the GFC.

We have squandered the proceeds of the mining boom. In the early years of this century, when we should have been investing in infrastructure and education, and putting some away in a sovereign wealth fund, we spent those proceeds on middle class welfare and tax breaks for the rich. Treasurer Hockey is now trying to make the most disadvantaged pay for that profligacy.