ABC BULLION EDUCATION

Why low interest rates won't save the Australian economy

Since the 'recession we had to have' in the early 90s, Australia really has been the economic lucky country, recording perpetual Gross Domestic Product (GDP) growth for over two decades. This success can be attributed to a number of factors.

The first has been double decade trend toward lower interest rates. With the high inflation that the late 1980s contained, the Reserve Bank of Australia (RBA) was able to reverse its monetary policy course in the early 1990s, cutting interest rates sharply, from well over 15% toward the 2.75% level they are at today.

The second factor was productivity growth, which rebounded strongly in the 1990s, and accounted for the lion's share of the growth in our national income that decade.

Following the turn of the century, our economy continued its strong run, this time sustained by the mining boom, which led to an explosion in our terms of trade, and saw capital expenditure in the mining industry alone grow from around 1% of GDP in 2000, to 3% in 2008 and to over 7% today.

Gross household debt also continued to accelerate, rising nearly 3-fold relative to national income across two decades, fuelling an unprecedented property boom.

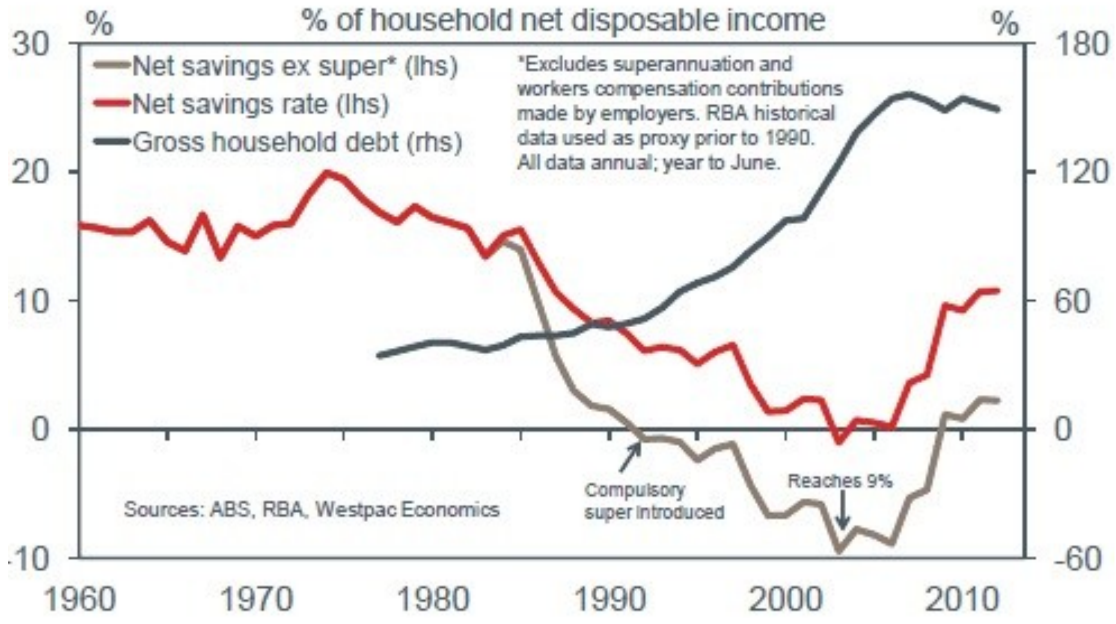
To give a sense of scale of how big the boom in Australian land and home values has been, consider the following metric, which measures housing assets divided by GDP in a number of nations.

Country	Housing Assets*	GDP*	Ratio
Australia	4.9 trillion	1.5 trillion	3.26
United Kingdom	4.3 trillion	1.5 trillion	2.82
Canada	3.1 trillion	1.8 trillion	1.78
United States	18.5 trillion	16.0 trillion	1.15

*Source: RP Data, RBA, ONS, Stats Canada, Fed Reserve (in local currency)**

Finally, a declining savings rate, which went negative in the years preceding the global financial crisis (GFC), stimulated demand in retail, tourism and manufacturing amongst other sectors.

The declining national savings rate, and the increase in household debt, are captured neatly in the chart below.



Not surprisingly, with most sectors of the economy firing, Australia continued to record impressive growth rates, averaging approximately 3.75% per annum in the 16 years up until 2008 and the onset of the GFC.

The post-GFC world

A combination of much lower interest rates, large budget deficits, and an unprecedented stimulus package from China (in percentage terms larger than the United States) allowed Australia to survive the GFC, at least for those who were focusing only on GDP growth as the measure of 'success'.

Certainly this was the opinion of both the government and treasury, who only a year or so back predicted we would be back in surplus by now.

In reality though, the pick-up in Australian economic activity post-GFC was a 'dead cat bounce', purchased as it were, with government debt. China's role also further compounded our reliance on capital expenditure in the mining sector.

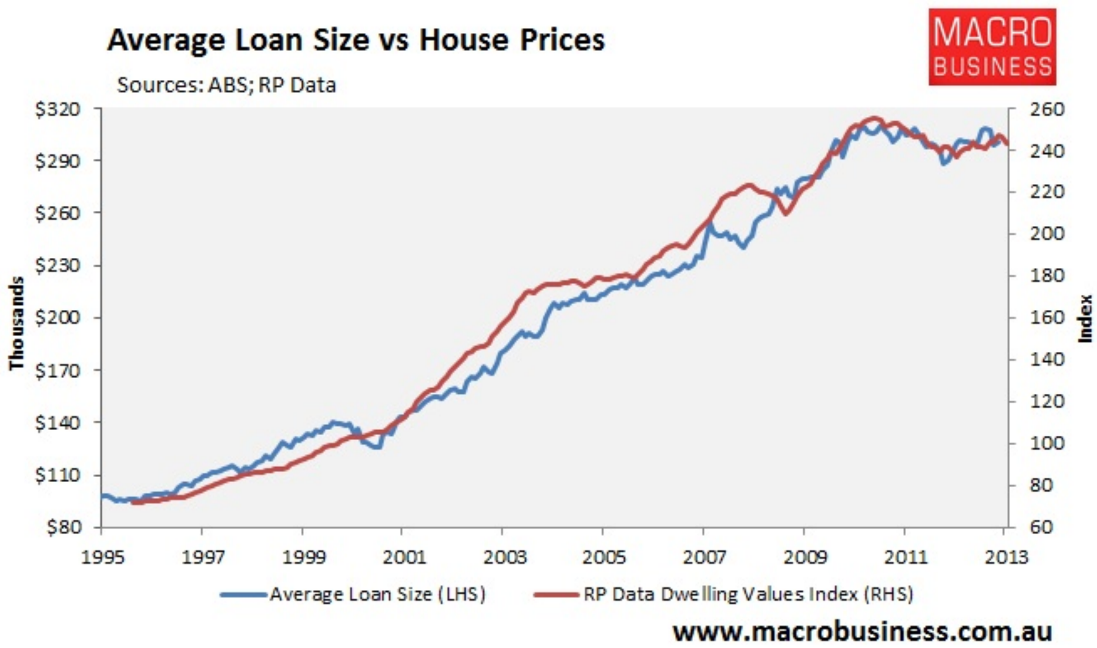
Today, it's obvious that the best days of the mining boom are now behind us, with estimates from a number of banks and the Bureau of Resources and Energy Economics highlighting that capital expenditure in this sector will reduce to around 2% of GDP over the next few years, detracting roughly 1% from growth each year over this period.

And, while the great hope of both the RBA and the government is that housing, manufacturing (in outright contraction for years) and other non-mining investment will pick up, the reality is that Australians are now far too indebted to open up their cheque books, even in the face of lower borrowing costs.

Interest rate deductions no longer work to stimulate demand as they once did because debt levels today are so high that Australians are spending a higher percentage of their disposable income servicing the mortgage now than they were when interest rates were well north of 10%, two decades ago. Compounding this debt problem, Australians have little genuine free cash flow to spend.

While mainstream commentators talk about our net savings rate it is this rate ex-superannuation, which more accurately reflects the free cash flow position of most Australians. As the previous graph shows, that number is still close to zero!

Therefore, whilst lower rates are making mortgages easier to service, they are no longer enough to encourage Australians to go deeper into debt to fund housing purchases, with the average value of home loans unchanged in the last few years. As the following chart shows, this had been critical to the growth in home prices.

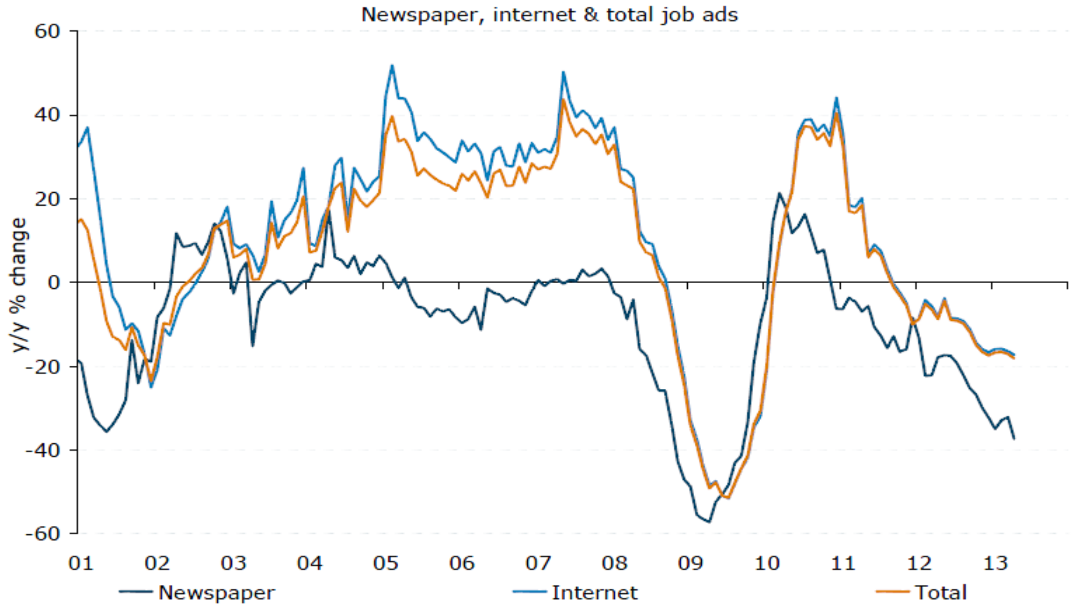


The caution in Australian households has been picked up in the wider business community, with capital expenditure and hiring intentions in the non-mining sector weak if not outright negative.

Unemployment and lack of jobs highlight real economic outlook

There are a number of factors one could point to which illustrate the current weakness in our economy, and the uncertain outlook ahead, but it is perhaps best captured by looking at the number of jobs advertised.

As you can see from the graph below, the year-on-year change is decidedly negative, approaching the kind of lows last seen during the depths of the GFC.



Source: ANZ monthly jobs survey

The noticeable decrease only compounds the problem of a rising unemployment rate, heading toward 6% officially, but in reality much higher.

Research from Roy Morgan, who more accurately account for the underemployed and discouraged job seekers than the ABS, shows that the true unemployment rate is closer to 10% already, and trending up.

The myth of a weaker dollar as our saviour

One thing traditional economists and the mainstream financial media agree on is that a lower AUD is essential to help re-balance our economy and stimulate growth. It is nearly always presented as a good thing.

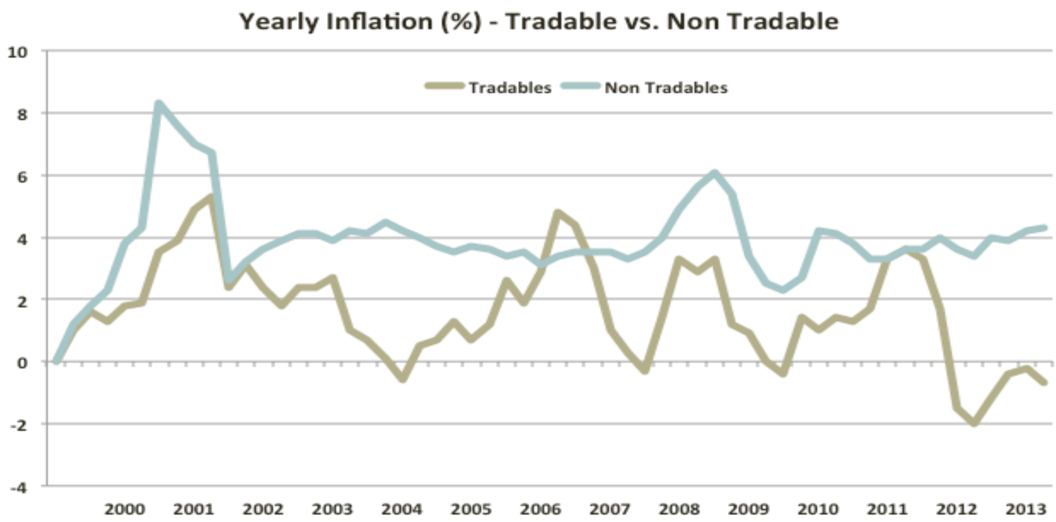
Whilst there is no doubt it helps improve the competitiveness of our export industries, and encourages tourists to come here on holiday, a lower dollar is **bad news** in a lot of ways.

Firstly, a falling Australian dollar discourages foreign capital.

If the consensus opinion is that the AUD will continue falling, common sense suggests foreigners will be wary of investing into Australia until the worst of that fall is behind them. This has negative implications for our economy and our asset markets
A falling AUD also leads to an increase in the cost of everything we import, something most Australians are painfully aware of every time they fill their car up, with petrol prices almost back at all-time highs.

The high dollar has actually helped keep inflation in check these past few years, as tradeable inflation (i.e. things we can import like TVs and white goods) has been benign.

This is shown clearly in the below chart of tradeable vs. non-tradeable inflation.



Source: Australian Bureau of Statistics

As you can see, non-tradeable inflation has been consistently running around 4% for many years. The strong dollar helped keep overall inflation low, as import prices have been well controlled.

This will change with a weaker dollar, leaving less money in our wallets, hardly ideal when employment and wage growth are weak.

Furthermore, while official inflation readings are benign, a look-through the inflation data makes it clear the 'real' cost of living impacting Australians is rising at a significantly faster pace than the official rate.

Inflation Statistic	Annualised Average rate since 2009
Headline Inflation	2.5%
Housing	4.8%
Property Rates	5.7%
Education	5.8%
Insurance	6.6%
Medical	6.8%
Child Care	7.6%
Electricity	14.4%

Source: Australian Bureau of Statistics

High inflation, coupled with Australians' sensible aversion to more debt is the major reason our retail sector has struggled so much these past few years.

Conclusion

Australia has had an incredibly good run the past two decades, but the engines of growth (mining, debt, and productivity) have stalled.

The unprecedented housing boom will likely be followed by a long period of stagnation, at best. And while phase three of the mining boom still has a long way to play out, we've already experienced the best it has to offer us in terms of employment growth and our national income.

Lower rates and the Australian consumer will not save us this time around. They are burdened down by too much debt, which for most is invested in a non-income producing asset.

Coupled with little in the way of genuine free cash flow, the reality of constantly rising prices for essentials, and with an uncertain outlook on the employment front, caution will remain their buzzword. This period of belt-tightening is a trend that will remain in place for many years, impacting employment, company earnings and asset markets.

With fiscal and monetary policy already highly accommodative, and the challenge of the ageing population ahead, there is little authorities can do, other than following the American path of zero interest rates, money printing and perpetual increases in government debt.

While this may well happen, it will only exacerbate the imbalances in our economy. Investors would be wise to re-assess their strategies and to ensure their portfolios are appropriately positioned in light of these realities.

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