Australian central bank report points to credit bubble

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In recent years the Australian economy appears to have been something of an exception with regard to global trends. While Europe, the United States and Japan have been experiencing low, or even close-to-zero growth rates, the Australian economy has been expanding by 3-4 percent annually.

The image that the Liberal government Treasurer Peter Costello likes to present is one in which the good ship “Little Aussie Battler”, with his hand firmly on the wheel, rides out the storms of the global economy.

However, the real reasons for the seeming “exceptional” status of the Australia economy have little to do with so-called “sound economic management” practised by the government. Rather, as a report issued last week by the Reserve Bank of Australia (RBA) makes clear, they are to be found in financial processes which have led to the formation of a credit growth bubble.

According to the RBA’s quarterly statement on monetary policy, household debt in Australia is growing at a faster rate than in any other major economy and could be creating the conditions for a sharp downturn in the future. In other words, the faster than average Australian growth rate is not an “exception” to the processes governing the rest of the world economy but rather a manifestation of one of the most significant global trends of the recent period—the increase in debt and the creation of financial bubbles.

The report showed that the annual growth in household borrowing in Australia last financial year was 19.6 percent compared to 10.3 percent in the US, 9.4 percent in Britain and 8 percent in Canada. Since 1995, the average annual growth in Australian household borrowing has been 14.2 percent, surpassed only by Spain with 15.7 percent.

The RBA said that monetary policy was complicated by the “rapid growth of credit and its flow-through into rising housing prices. Currently, credit to the household sector is growing at an annual rate of about 20 percent, well in excess of what could be considered sustainable in the medium to longer term.”

“The risk presented by these developments is that, the longer they go on, the larger will be the contractionary effect on the economy when they inevitably turn.”

The RBA said that while banks reported that they were taking a “prudent approach” to lending there were “signs of worrying practices elsewhere in the financial system.” “This is not untypical of a prolonged bull market, and could cause a great deal of distress to the economy when the housing price cycle turns.”

The rapid increase in borrowing since the mid 1990s has seen the ratio of household debt to gross domestic product double. Over the same period, however, business credit has shown an annual growth of around 7.5 percent and, as a share of GDP has changed little since 1987.

A key component of the credit boom has been the rise in house prices, itself fuelled by increased debt. Bureau of Statistics figures also released last week show that lending to home investors rose 8.4 percent in June to a record $A6.88 billion, which is 37 percent higher than a year ago. Lending to owner-occupiers increased 6.7 percent in the month, a 21 percent annual rise.

The RBA estimated that the practice of borrowing against rising household values to finance other forms of spending had augmented cash flows to households by about 4 percent in the past year. In the short term this process could continue but if Australia were to enter a period of declining house prices “it is likely that this equity withdrawal would be scaled back, or would possibly go into reverse, resulting in a cutback in spending, with a potentially destabilising effect on the broader economy. The risk of a large impact from such an event will be greater the longer these current trends in credit and housing markets persist."

The report found that the pace of credit growth in Australia was "unusually fast" by international standards, with most other countries experiencing credit growth of between 6 and 9 percent per year. One of the main factors in the increase appears to have been the decline in nominal lending rates. Households are now able to borrow twice as much relative to income compared to the late 1980s, while maintaining the same debt service ratio. The belief that interest rates will stay low has also led to increased borrowing, "resulting in a significant upward shift in the ratio of household debt to GDP, and thus a period of above-average credit growth."

"However, at some point this transitional process must come to an end, which would require household credit growth to return to something more closely in line with the growth of nominal GDP."

While there was no firm benchmark as to what constituted a "normal" relationship between credit growth and GDP, it was clear that "the current pace of household credit growth in Australia exceeds any reasonable benchmark by a fair margin" and standing some 14 percentage points above GDP growth, household credit growth was clearly "faster than is sustainable in the medium term."

The RBA noted that in the past when credit booms had ended they had often resulted in "financial and economic instability, with banks suffering losses and the business and household sectors cutting back spending." In the present situation, it said, as far as could be judged, there was not a "direct risk" to the financial system. However, household consumption was now much more sensitive to changes in economic conditions and there was a risk that if the rapid increase in borrowing continued, households at some point would need to "adjust the structure of their balance sheets with potentially adverse consequences for the economy and financial institutions."

But what, if anything, is to be done about this potential danger? Not every much it seems. The RBA noted that the weakening world economy and the credit boom within Australia had conflicting implications for monetary policy. A weakening world economy implied a cut in interest rates—in line with cuts in the US and Japan. However, a cut in interest rates would further inflate the credit bubble with potentially destabilising consequences for the economy in the future.

Faced with this dilemma, the RBA appears to have decided to sit pat in a demonstration of another global economic trend—the increasing paralysis of institutions charged with regulating the capitalist economy as they confront processes rapidly moving out of their control.