Billions wiped off Australian share market

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Australian share prices have plummeted since the start of 2008, driven by the exposure of local banks and financial institutions to the US credit crisis. It is becoming increasingly clear that the Australian economy as a whole is far from immune to the impact of a US recession, despite a prolonged local boom based on mining exports.

By January 19, more than $147 billion had been lost from the value of shares since the beginning of the year, with the S&P/ASX index down some 9 percent. It was the 10th consecutive fall, the longest run since September 1990. The index had fallen 15.8 percent from its peak of 6828.7 points on November 1, also marking the weakest start to a calendar year for 17 years. Since the US sub-prime collapse began in the middle of last year, the market has now fallen twice by more than 10 percent.

The latest price slide, which has been accompanied by large losses across East Asian markets, has exceeded the falls on Wall Street itself. According to the *Australian Financial Review*, the Australian market has suffered its "worst losing streak since 2000"—when the dot-com bubble burst—"as increasing concerns that the United States is in the grip of recession ramped up the sell-off across global equities".

Among the immediate reasons for the turmoil on the Australian Stock Exchange has been the widening fallout from the $4 billion meltdown of Centro, the country's second largest shopping centre property group. Centro's share price dropped a further 47 percent on January 16 and 17 after the resignation of its chief executive. The company, which borrowed heavily to buy US shopping malls, lost more than 80 percent of its market value in December when it revealed it had been unable to refinance its debts as a result of the global credit market squeeze.

Last week, UBS Property Securities Fund, one of Australia's largest, reported a loss of 22.32 percent for the six months to December. With more than $1.8 million in assets as of September, the fund was named Australia's best property fund in 2006. But it had piled almost 14 percent of its investments into Centro.

Another factor in the share plunge has been revelations that Australia's four major banks—the CBA, NAB, ANZ and Westpac—have a $1 billion direct exposure to the US subprime mortgage market through their participation in an international deal to rescue the largest US mortgage provider, Countrywide Financial, which remains in serious trouble. This exposure may be the tip of an iceberg, involving further Australian efforts to help bailout US and British finance houses.

Reports emerged last week that Australian investment funds hold almost $30 billion in unsecured "kangaroo bonds" linked to US and British financial institutions, many of which have been hard hit by the worsening credit crunch. The troubled US financial institutions Citigroup and Morgan Stanley have almost $5 billion in outstanding bonds each. Others on the list include Merrill Lynch ($3.9 billion), Goldman Sachs ($2.7 billion), Bear Sterns ($2.1 billion), the virtually collapsed British bank Northern Rock ($1.2 billion) and Countrywide Financial ($925 million).

The identity of the Australian bond holders is not yet known, but they are thought to include superannuation funds, putting at risk the retirement funds of millions of ordinary people.

The conception that the minerals boom will shelter Australia from the US crisis is beginning to unravel. Corporate economists have admitted that the Australian economy could be more damaged by a US downturn than initially predicted. UBS chief strategist David Cassidy told the *Australian*: "If the US does enter a fully-fledged recession, then there will be more downside in the US markets. But there will be more pain to be felt in Australia."

While mining exports have soared to China, the US remains the largest source of foreign investment in Australia (more than 25 percent) and a major export market (about $3 billion a year). Moreover, China and Australia's other major raw materials export markets in Japan, South Korea and throughout East Asia are also closely linked to the US economy.

Even with near-record base metals and other commodity prices, Australia has a chronic balance of payments deficit and a mounting foreign debt. Reserve Bank statistics indicate that net foreign debt grew from 15 percent of GDP to more than 50 percent between 1985 and 2007.

At the same time, the domestic economy, like that in the US, has become heavily dependent upon retail sales, particularly in household goods, financed by historically unprecedented levels of consumer debt. Household debt soared from less than 40 percent of household disposable income (HDI) in 1985 to about 160 percent in 2007, with interest payments almost doubling, from just over 6 percent to 12 percent of HDI.

As a result, households, particularly in working class areas, are facing previously unheard-of levels of indebtedness. These have far outstripped real wages, which have risen 25.6 percent since 1990. Households have borrowed (mortgage re-financing, credit cards, store cards, etc.) to offset stagnating real wages and cover day-to-day expenses. This will no longer be possible under conditions of falling property prices and rising interest rates.

Signs of deep financial distress are already emerging. Credit defaults rose by 28.6 percent from 2006 to 2007, with the highest rises in outer-suburban "mortgage belt" areas in Sydney (43.5 percent), Brisbane (44.4 percent) and Melbourne (40 percent) as well as in drought-affected rural areas, where defaults rose by as much as 60 percent.

The seriousness of the situation is already impacting on popular consciousness. The Westpac-Melbourne Institute index of consumer sentiment fell 8.3 percent this month, driven down by a 20 percent fall in expectations about economic conditions in the year ahead. Sentiment among Labor voters fell by 11.5 percent, nearly double the fall among Liberal-National Coalition voters. The index dropped to its lowest point since November 1996.

Like their counterparts in the US, the Reserve Bank of Australia and the Rudd government are caught in a dilemma. Because of rising fuel, housing, healthcare and credit costs, domestic inflationary pressures are intensifying, even as a global slump threatens.

The TD Securities-Melbourne Institute monthly inflation gauge rose 0.6 percent in December, lifting the annual reading to 3.7 percent—well above the Reserve Bank's target range of 2 to 3 percent. Everyday expenses soared, including petrol (17.2 percent), rent (8.6 percent) and health and medical services (5.9 percent).

In an effort to dampen inflation, the Reserve Bank could raise the official interest rate by 0.25 points at its next meeting on February 5—the seventh such increase since 2004. This month, the five largest private banks increased mortgage rates by between 0.12 and 0.2 percentage points, on top of the Reserve Bank's 1.5 percentage points since 2004, blaming higher funding costs due to the credit crunch.

Last week, Prime Minister Kevin Rudd and Treasurer Wayne Swan held a rare joint meeting with Treasury secretary Ken Henry, Reserve Bank Deputy Governor Ric Battellino and other bank officials on the economic situation. In a written statement after the meeting, Swan pledged to meet business demands for severe cuts in the government's first budget, due in May. "It's critical we demonstrate restraint as we frame our first budget because that sends a clear message to the RBA [Reserve Bank] that the commonwealth government will do whatever is in its power to put downward pressure on inflation," Swan declared.

The Business Council of Australia (BCA), representing the biggest 100 Australian-based companies, earlier demanded deeper budget cuts than the $10 billion over four years already promised by the Labor government. BCA president Greig Gailey urged the new government to scrap some "costly" promises made during last November's election campaign. "The first budget is going to be absolutely critical because lots of promises [were made] during the election and the economy may be not looking quite as rosy."

Rudd made clear he had heard the message. Interviewed by the *Sun-Herald*, a Murdoch tabloid, he said: "To meet the inflation challenge left behind by the previous government and put downward pressure on interest rates we will embark on a new era of fiscal discipline. We have already kicked off a rigorous review of spending that will see us announce substantial additional savings in the 2008-09 budget in May."

To soften public opinion for painful cuts, the government announced that the Department of Foreign Affairs and Trade—where Rudd once worked as a diplomat—would trim its budget by $57 million, with a number of overseas diplomats to be recalled. "The whole of the national Government needs to tighten its fiscal belt," Rudd said. "That means the Department of Foreign Affairs as well."

Finance Minister Lindsay Tanner said the government would aim for a higher budget surplus than the $14.4 billion estimated by the Howard government for the next financial year. This would mean finding savings worth more than $1 billion in 2008-09, on top of the $10 billion over four years. While claiming to target "waste" and "mismanagement," Tanner refused to nominate the specific areas where cost-cutting would occur.

The most serious cuts are certain to come from social programs already gutted over the past quarter century by the Howard government and by the Hawke and Keating Labor governments that preceded it. Among the savings previously announced by Tanner are the scrapping of a planned dental program ($372 million), the expansion of a Centrelink compliance campaign designed to cut welfare payments ($160.2 million) and reduced spending on youth and student allowances ($94.1 million).

Tanner pledged to extract a so-called efficiency dividend of 3.25 percent from nearly every public service, and refused to rule out redundancies. He insisted that "current vacancy rates, turnover and attrition" would help but when asked whether he could guarantee that no public redundancies would result, he simply said, "we say we believe there will be no need for redundancies".

By contrast, Tanner guaranteed that the promised $31 billion tax cuts, which predominantly benefit the highest-income earners, would proceed, and that military operational spending would be exempt from the across-the-board savings target. None of the ongoing military and police interventions in Iraq, Afghanistan, East Timor or Solomon Islands will be affected, nor will the Howard government's plans for substantial expansions of the armed forces and the international deployment unit of the Australian Federal Police.

In other words, like the Bush administration in the US, Labor is fully committed to imposing the full burden of the economic crisis directly on the backs of ordinary working people.