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"Debt bubble economics" rules

Dominic McCormick | Select Investment Partners | 06 May 2016

Australia has one of the largest household debt to income ratios in the world, at over 180%. It has almost tripled from around 65% in the early 1990s. At almost 130%, our household debt to GDP is also amongst the world's highest. Most of this is mortgages taken on by existing home owners and increasingly desperate new home buyers, as well as investors, many of whom are attracted by the benefits of negative gearing and historically low interest rates.

One might have thought a responsible government would be concerned by this high and growing level of debt and would be considering or introducing policies to reduce it - or limit its growth, at least. Yet arguably, many of the policies being adopted including some in this week's Federal budget effectively do the opposite.

Arguably, this Budget along with the Research Bank of Australia (RBA) official interest rate cut to 1.75% on the same day, further undermine traditional safe forms of saving and push investors further up the risk curve. It seems to give Australians the "all clear" to keep taking on debt to purchase increasingly overvalued, owner occupied and investment property (and, possibly, shares).

In addition, the Budget cuts incentives to contribute to and build large superannuation balances, a policy which may seem sensible on a stand-alone basis but which may have adverse implications when other changes or perhaps more importantly "non changes" are considered. Specifically, the structural incentives to pour money and borrowings into larger tax-free residential homes, irrespective of whether this suits the investor's needs, remain as strong as ever. This is also the case for gearing into property, given the tax benefits of negative gearing and concessional capital gains tax on sale (if held for greater than 12 months). Of course, other investments such as shares can also be negatively geared but they are seen as much riskier than property and the level of leverage available is significantly lower.

Despite saying he wanted to reign in the "excesses" of negative gearing just a couple of months ago, Treasurer Scott Morrison has since become the chief cheerleader for maintaining the negative gearing arrangements that are a key contributor to this household debt mountain and overvalued property markets. In the Budget speech he said:

> "We will not remove or limit negative gearing - that would increase the tax burden on Australians just trying to invest and provide a future for their families. Those earning less than $80,000 a year in taxable income make up two thirds of those who use negative

> gearing... We do not consider that taxing these Australians more on their investments, including increasing their capital gains tax and undermining the value of their own home and investments, is a plan for jobs and growth".

Of course, there is the delicate issue that some people use negative gearing to get their taxable income down from higher levels to under $80,000, exactly because of the negative gearing interest deductions – and, often, on multiple properties. In any case, are some of the lower income earners the Treasurer refers to (nurses, policemen, etc) really suited to the level of risk they are taking on in by aggressively gearing one or more properties in an already heated property market?

While the government may not wish to directly undermine the value of Australian homes, it is not the government's job to underwrite policies that push up house values and the debt levels against them, higher either – particularly given the challenge that home ownership is becoming for younger generations.

In a 2005 speech, Turnbull called negative gearing "tax avoidance" according to Jeff Kennett. It seems the desire to distinguish the Liberal position and be able to attack Labour's negative gearing policy during the upcoming election campaign (the policy certainly has some flaws) was more important than actually doing the right thing by the Australian economy. And we wonder why people across the western world are losing faith in their politicians!

There is no doubt the current investment environment is extremely challenging for investors as they are pushed to take more risk through credit, equities, property and geared versions of these. However, investors should not underestimate the risks that can develop in such a debt bubble economy.

Meanwhile, the RBA seems complacent, for now at least, about the risk that its latest interest rate cut causes further increases in housing prices. The RBA stated in its latest release this week that "supervisory measures are strengthening lending standards and that price pressures have tended to abate". Clearly, it is banking regulator APRA that is doing all the heavy lifting in managing the risks of growing household debt and high property prices. Clearly, APRA's measures to encourage tighter lending standards by banks are having some impact – but, it remains to be seen whether these outweigh the impact of the RBA's interest rate cuts and government policies that maintain property and gearing into property as sacred cows.

At least the RBA is thinking about the issues. The impression is that the government doesn't even understand the issues or, in its focus on winning the next election, simply doesn't care.

Some commentators have focused on how far ahead many borrowers are on their home loan repayments currently and how mortgages as a percentage of current house values are comfortable currently. But this is like judging the effectiveness of an umbrella with holes in it on a clear day. Australia has not had an official recession for 25 years and a serious downturn would be a real test for many. Rising interest rates could be another challenge at some point.

The RBA and government seem overly confident that things will be fine, as the combination of looser monetary policy and budget initiatives increasingly push people into fewer and riskier asset classes and, most worryingly, the high debt involved in some of these (especially property).

The distortions created by policy don't stop at action and non-action in the Budget. Despite David Murray's Financial System Inquiry calling for gearing in super to be banned (a view I agree with), the Government chose last year to allow gearing via limited recourse borrowing arrangements (LBRAs) to continue, and it is being embraced increasingly as an additional way to leverage into property.

Indeed, given the increased restrictions on the size of tax deductible and undeducted contributions, there is a risk that the use of geared property in super may actually continue to increase as members try desperately to increase returns. Increasingly, excessive exposure to (overvalued) property becomes the key driver of returns in these SMSFs, and sensible diversification and risk management is thrown out the window. When a major property downturn eventually comes, some of these funds will prove disastrous for members by failing to meet their retirement needs.

And, it's not just the tax system and low interest rates that encourage buying property taking on large debt to acquire it. A social security system that allows and encourages individuals or couples to remain in large, multi-million dollar houses well in excess of their needs, in order to gain access to the full or part pension and leave the asset to their family is clearly in need of radical change.

When will politicians have the courage to properly address these issues?

Some believe that policies that help to reign in household debt and/or property prices will cause a severe correction or crash, and badly impact the economy. Perhaps - but policies introduced gradually may reduce this risk. (This is one of the flaws of Labour's negative gearing policy). Further, lower debt and property prices would actually be positive for some and eventually bring about a more balanced and stable economy, even if there is some pain for a period. In any case, there is no easy way out from the top of a debt bubble and simply trying to avoid the problem by making the bubble larger is likely to create a bigger problem down the track.

Australia, like much of the western world, is increasingly resorting to a policy (if you can call it that) of "debt bubble economics". That is, the aim is to keep households feeling wealthy and continuing to consume by maintaining or encouraging measures that support or increase asset prices. However, that can only be done by growing household debt levels further from already dangerous levels. And this is exactly what has caused bubbles and major busts in the US and other economies in recent decades.

The irony of the entire situation is that much of the world is, in effect, supporting a debt and asset bubble to deal with the slow growth and low inflation environment that is at least partly the result of... a previous debt and asset bubble! Further, little attention is being paid to the distortions and wealth inequality this path causes, as the rich benefit most from rising asset prices and first home buyers are increasingly priced out of the market. It's time for true leaders and sensible policy on these issues, not simply short-term focused cheerleaders for more debt and higher asset prices.

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