NARROW ROAD CAPITAL

Is Australia Ready for the Next Financial Crisis?

Ten years on from the Global Financial Crisis and the threat of another financial crisis in the medium term is now a solid possibility. There are signs of weakening economic growth in China and the US, with Europe and Japan showing no signs of getting out of their long term economic funks. Global debt levels are well above where they were before the last crisis with dumb lending prominent across government, corporate and consumer debt sectors. Elevated asset prices corrected somewhat in 2018, but many asset classes are still priced well above historical average levels. These indicators don't guarantee another financial crisis (e.g. late 2015/early 2016), but they do point to the risk being higher than normal.

In light of this increased risk, it is worth considering how prepared Australia is for a potential financial crisis. Has Australia become complacent after escaping largely unscathed from the last one? Have governments and regulators acted to lessen the likelihood and severity of a potential downturn? This article considers these questions for the banking/financial system, monetary policy, fiscal policy, taxation policy and competition policy.

The Banking/Financial System

Australia's banking system proved more resilient in the last financial crisis that many of its peers from a combination of good luck and good management. Australia's banking regulator, APRA, is widely regarded as amongst the most conservative regulators and this definitely played a part in dampening risk taking. It also helped that Australian banks are themselves fairly risk adverse, with limited pockets of dumb lending emerging in the 2004-2007 period. The near death experiences were contained to the regional banks and foreign entrants, with timely government/regulator intervention ensuring that no collapses occurred.

The shallower downturn that Australia experienced in 2008-2010 was partly due to these factors and partly due to the economy generally suffering less than other countries did. These two reasons are intertwined in that a well regulated financial system leads to fewer and shallower crises. Higher risk financial systems can experience long and deep periods of economic underperformance, as Europe and Japan have demonstrated. **Cutting off dumb lending before it becomes a bubble is paramount**.

In this regard, Australia currently finds itself reasonably well placed. Corporate lending, which typically is the cause of the largest losses for banks in a downturn, has few sectors of dumb lending. Australian leveraged loan and high yield bond markets have grown but remain a small part of overall credit provision. There are few large Australian corporates that carry deep sub-investment grade ratings (or would qualify for those if rated) and these companies are typically funded by US loan and bond markets. Arguably the worst placed corporate sector is infrastructure debt, with very high levels of leverage and limited covenants present on some recent transactions.

The primary concern for Australian banks is their exposure to residential property. Fortunately, this has not escaped APRA's attention with a crackdown on lax lending practices beginning in 2014. It is rare that a banking regulator has the foresight to lean against riskier lending before a downturn but APRA has achieved this feat. Increasing risk weights for riskier loans and increasing bank capital levels as part of the global total loss absorbing capital (TLAC) reforms are also very helpful in building buffers against a potential future downturn.

I argued that APRA should have taken action on these areas back in 2016. APRA has now announced polices on these areas, but the implementation period stretches to 2023. Should the next financial crisis begin in 2019 or 2020, the delays in implementing these reforms will be lamented. Overall, Australia's banking and financial system is reasonably well prepared for the next financial crisis with the position improving steadily as TLAC reforms are implemented.

Monetary Policy

Unlike APRA, the Reserve Bank of Australia (RBA) has completely misunderstood the impact of its decisions on the residential property market and financial system stability. Like many other central banks, the RBA has taken far too long to recognise that ultra-low interest rates create debt and asset price bubbles but do very little to encourage sustainable economic growth. At the time when APRA was working to reduce the building risks in residential property lending in early 2015, the RBA chose to pour fuel on the fire with interest rate cuts totalling 1% over 18 months.

Those who listened to lenders and real estate agents as these cuts occurred know that each 0.25% rate cut stimulated additional demand to purchase residential property, mostly from investors. Had the RBA kept the overnight rate unchanged in 2015 and 2016, **house prices would have stopped increasing much earlier and the price falls seen in the last year may not have occurred**.

The RBA now finds itself in a position of negative real interest rates, a position made worse when tax rates are included in the calculations. Whilst never publicly acknowledged, the RBA has a strong academic position that savers should be punished and borrowers should be rewarded. It believes that implementing this position encourages productive investment, despite substantial evidence that almost all it does is encourage speculative investing and asset price bubbles. The foolishness of this academic position has been exposed many times in history, with the 2004-2007 bubble in US residential lending the most obvious example.

At a time of reasonable economic growth and low unemployment, overnight interest rates in Australia should be at or at least moving towards a neutral level, just as they are in the US. **The lack of discussion and debate over this bizarre position indicates that the management and board of the RBA is captured by groupthink**. Correcting this would require an injection of people with expertise in the functioning of credit provision and debt markets, something clearly lacking in backgrounds of existing senior management and board membership. The failure to normalise interest rates at the appropriate time has made Australia significantly more financially unstable. It also leaves the RBA with little room to respond to the next financial crisis.

Fiscal Policy

The outlook of a small federal government surplus for the 2019/2020 year is a positive development. However, it has come far too late with Australian government debt allowed to escalate over a decade with little regard for the consequences of increased debt levels. The federal politicians of the past decade have been far too keen to play Santa and have mostly been unwilling to cut unnecessary and wasteful government spending.

Traditional Keynesian policy advocates for deficits in the bad times and surpluses in the good times, something Australia did very well on in the late 1990's and first half of the 2000's. Peter Costello's legacy of no net debt gave the Rudd government the ability to stimulate the economy when the last financial crisis began. It should be remembered that this spending was mostly wasteful and short term, with little infrastructure developed. Should a financial crisis begin in the medium term, Australia's budget position will offer limited ability to stimulate and certainly far less than was possible in 2008/9.

Taxation Policy

The repeated inquiries into taxation settings in Australia (Henry 2010, Tax White Paper 2015) shows that politicians understand that we have a sub-optimal tax system. The lack of courage to implement anything more than piecemeal reform has held back economic growth, increasing the problems discussed above with monetary and fiscal policy.

The good news on tax reform is that if implemented properly it would provide a meaningful and compounding boost to Australia's economy. The bad news is that polls have a Labor government likely to take over in 2019, with their stated policies including anti-business and anti-wealth tax changes. Encouraging businesses and individuals to take their capital (and therefore job creation) elsewhere is an unwise policy position in a world where governments are increasingly competing to attract capital and jobs.

Competition Policy

Australians have long been well served by the recommendations and actions of the Australian Competition and Consumer Commission (ACCC) and the Productivity Commission. Both bodies have consistently recommended to the Federal Government policies that would enhance competition and economic growth, often recommending action that goes against long standing government policy and vocal vested interests. The major economic reforms of the 1980's and 1990's created a foundation for Australia's record run of positive GDP outcomes.

Unfortunately, the last decade's crop of Federal politicians has largely given up on economic and competition reform. Vested interests have gained power, with the silent majority of Australians that are looking for better and cheaper, goods and services being neglected. It is often said "never let a good crisis go to waste"; perhaps the next crisis will provide some political cover to re-embark on overdue competition and productivity reforms.

Written by Jonathan Rochford for Narrow Road Capital on January 8, 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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