Debt – how does Australia compare?

8 NOVEMBER 2012

"High levels of debt are fine, until they're not"
"It's not what you own that gets you into trouble, but what you owe"

Key points

- Australia has a low level of total debt compared to other major countries. But while public and corporate debt is low, one area of greater vulnerability is household debt.
- A chronic current account deficit in Australia also means a degree of vulnerability to foreign investor sentiment – although this has been the case for decades.
- While Australia is not without debt risk, it is still relatively low, in part due to the flexibility to cut interest rates further, the buffer the $A provides during extreme shocks, pent up demand in the non-mining parts of the economy and the unlikelihood of a hard landing in China.

Introduction

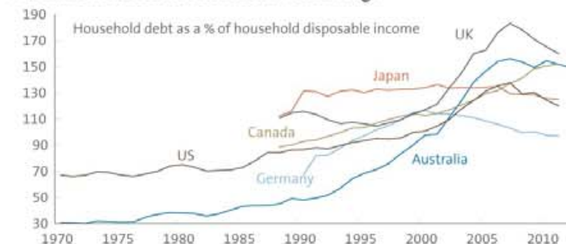
Since the global financial crisis, excessive debt has been a source of volatility and constraint for various countries, notably the US and Europe. Initially the focus was on the private sector and more recently, the public sector has drawn attention. Australia has relatively low public debt but how does it stack up in terms of total debt? This is particularly relevant in assessing the vulnerability of Australia should something go wrong, e.g. if China collapses and our terms of trade plummets.

Total debt outstanding

The next table shows total debt outstanding, i.e. public and private, as a percentage of GDP. As is well known, Australia's level of public debt is very low and clearly ranks a fair way down the list. Where Australia is a bit more vulnerable is in terms of private debt. This is largely due to a relatively high level of household debt.

Household debt in Australia rose strongly over the twenty years prior to the GFC as interest rates trended down, financial competition led to increased access to debt and relatively stable economic conditions while rising asset prices encouraged households to increase gearing levels.

Australian household debt levels remain high



Source: OECD, ABS, RBA, AMP Capital

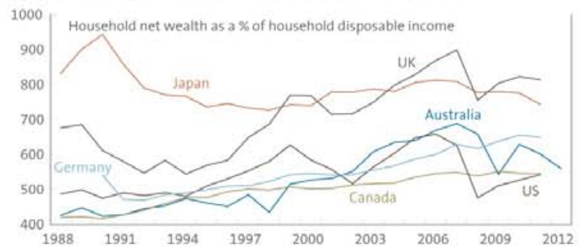
Debt outstanding, % GDP (2012 data)

Country	Public	Private	Total
Netherlands	68	680	748
Japan	237	392	629
Denmark	47	551	598
UK	89	460	549
Belgium	99	390	489
France	90	396	486
Spain	91	390	481
Sweden	37	420	457
Eurozone	94	361	455
Portugal	119	294	413
Norway	50	341	391
Korea	34	354	388
Italy	126	258	384
US	100	240	340
Australia	30	291	321
Hungary	74	241	315
Germany	83	225	308
Canada	88	190	278
Greece	171	103	274

Source: IMF, Haver Analytics, Ned Davis Research, AMP Capital

The financial crisis has brought a more cautious attitude to debt on the part of Australians, thanks to weaker asset prices, worries that house prices might go the same way as those in the US and parts of Europe and increased job insecurity. This has been accentuated by a tightening in lending standards. Nevertheless, debt levels have basically stabilised relative to income, in contrast to other countries where they have fallen, although this reflects loan defaults in the US to a large degree. What's more, with soft share markets and subdued house prices together with rising incomes in recent years, Australian household balance sheets, as measured by net wealth (assets less liabilities) relative to income, have deteriorated.

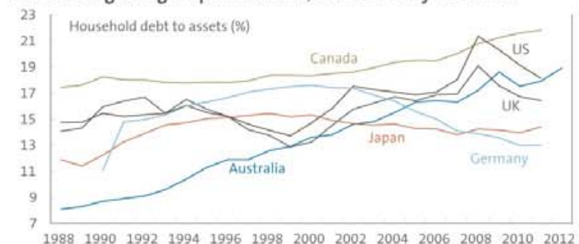
Australian household balance sheets have deteriorated



Source: OECD, RBA, AMP Capital

Similarly, soft asset prices at a time of stable debt levels have seen gearing rise, as measured by the ratio of debt to assets.

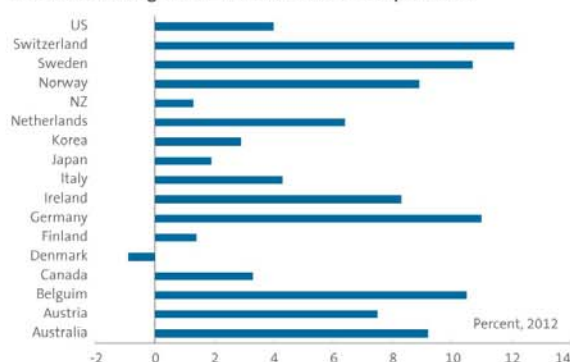
Household gearing is up in Australia, but is not way out of line



Source: OECD, RBA, AMP Capital

Against this, several points are worth noting. First, the household saving rate is now very high in Australia at around 10% compared to just 3 to 4% in the US. This reflects household caution which has seen large flows into bank deposits.

Household savings rates – Australia towards top of OECD



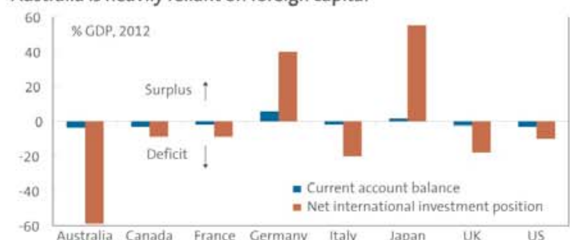
Source: OECD, AMP Capital

Next, the riskiness of Australian housing loans has been falling. Non-performing loans remain low. 'Low doc' loans are only around 5% of outstanding housing loans and less than 2% of new approvals. Additionally, around 50% of home borrowers are ahead on repayments and given that all Australian mortgages are full recourse, Australian's cannot simply walk away from their homes if they have negative equity. Finally, the Reserve Bank of Australia (RBA) has plenty of scope to cut interest rates further if required.

Foreign liabilities

One area where Australia clearly is more vulnerable is in foreign debt. Thanks to a chronic current account deficit ranging between 2 and 6% of GDP – even through the mining boom, Australia has remained reliant on foreign capital. As a result, net foreign liabilities, which include debt and equity (labelled 'net international investment position' in the next chart) is relatively high at 60% of GDP.

Australia is heavily reliant on foreign capital



Source: IMF, ABS, AMP Capital

Quite clearly, Australia would be vulnerable should foreign investors change their view on investing in Australia. However, this has been a risk since the 1980s!

1 See "Australia – the going gets tough for the lucky country," Oliver's Insights, September 2012, which discussed this scenario.

What's the risk?

While Australia's debt levels are not currently causing problems, they are not without risk. For example, just before the global financial crisis Ireland's public debt to GDP ratio was the same as Australia's is now, but this changed when house prices collapsed and banks had to be recapitalised.

The main risk is that something happens that severely affects the ability of households to service their mortgages and results in foreign investors changing their attitudes towards investing in Australia. Obviously, the RBA is unlikely to trigger the former by raising interest rates too far as it seems very sensitive to household fragility.

The prime risk is that China has a hard landing, causing a slump in Australia's export earnings, a sharp rise in unemployment, defaults, bank problems necessitating recapitalisation by the Government and a loss of confidence on the part of foreign investors.[1]

However, while this is clearly a risk, several factors are worth noting. Firstly, the tolerance for a hard landing in China is very low in view of the social unrest it would trigger and in any case, recent Chinese economic indicators suggest that growth there may be bottoming around 7.5%.

Secondly, while house prices remain overvalued, the risk of a house price collapse remains low given undersupply, low loan to valuation ratios and full recourse loans in Australia.

Thirdly, if the economic environment for Australia sours significantly, there is still plenty of scope for the RBA to cut interest rates – in fact 325 basis points worth, which would roughly translate to a fall in the standard variable mortgage rate to 4% if the banks' continue to pass on 80% of the RBA cuts. This would translate to an annual interest bill saving of around $6,500 for someone with a $300,000 mortgage.

Fourthly, unlike the situation in countries like Japan or peripheral countries in Europe, Australia's currency acts as a countercyclical buffer and would likely collapse if there were significant falls in Australia's export prices (the declines so far have not been major so the fact that the $A is around $US1.04 is not surprising). This could see the $A easily fall back towards $US0.60, delivering a massive boost to industries such as manufacturing, tourism and higher education which have struggled through the mining boom.

Finally, pent up demand exists in big parts of the Australian economy, in part due to measures to make way for the mining boom. Housing construction and retailing have been running well below capacity. This can be unleashed as mining slows and lower interest rates and a possible lower $A would be part of the mechanism to achieve this.

Concluding comments

Australia is not without its risks on the debt front and needs to continue down the path towards a budget surplus to be safe (to cap public debt) and for households to continue to run relatively high savings in order to boost their net wealth and cap household debt. However, the probability of a major debt crisis occurring is low as China is unlikely to have a hard landing, there is still plenty of scope to cut interest rates and the Australian dollar is likely to fulfil its role as a shock absorber in the event of a big loss to national income.

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