

Prosperity, not austerity, is our real problem

The horse has bolted, and now regulators are shutting the stable door. Frank Gelber asks: How do we get the horse back into the stable?

Compared with the rest of the world, Australia certainly has had a soft landing after the GFC-induced shock. The much-feared recession never eventuated. Unemployment peaked below 6 per cent.

That should come as no surprise. The situation facing Australia when the GFC hit was quite different from that in the rest of the developed western world. Even if we'd had a recession, it would have been a short-and-sharp collapse, a confidence-induced phenomenon, rather than anything fundamental. Indeed, it was precautionary saving that caused the Australian downturn.

Strong Government expenditure and hand-outs cushioned the outcome. And it's a return of confidence that's driven the recovery. Australia is now well into a recovery phase that will build momentum over the next few years.

By comparison, the US, the UK and parts of Europe had significantly overinvested. The falling asset values, which underpin much of bank lending, caused significant debt write-offs. They had a fully-fledged financial crisis, with economic outcomes exacerbated by a collapse of confidence and spending, and now face a long hard haul out of severe recession. They're doing what we did in the 1990s, only worse. They face long periods of weak investment as they absorb the excess capacity created during the boom. Meanwhile, Government spending will be constrained as

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they attempt to cut the budget deficits created in an attempt to cushion their economies. It'll take the US a decade or more to get its unemployment rate back down to 4 per cent. This is not a matter of a quick rebound. For much of the western world it's a slow rebuild.

There is no point looking at the GFC as the beginning, as an isolated shock. It wasn't. The GFC itself was caused by the excesses of the preceding financial engineering (FE) boom. It was an unwinding of the excessive gearing, the overvaluation in the overinvestment leading to oversupply caused by the FE boom.

Australia, too, went through a FE boom, but it wasn't as advanced. The FE boom left Australia over-gearred and, with the resultant weight of money, overvalued. But not overinvested. Had the cycle run its course, we would have oversup-

plied markets, but we were too slow into the game. In that sense, the GFC did us a favour, curtailing investment before we had a chance to oversupply.

For investment markets, of course, the three Os - overgearing, overinvestment, oversupply - constitute the major element of market risk. The first two can be solved with a financial market correction, and that's what has happened in Australia. The third is more difficult and takes longer to unwind, and that's what is happening in many other developed economies.

In Australia, the GFC triggered a correction, removing the above three elements of market risk. Market risk is now low, not high. With limited bad debts, Australian banks remain strong. We had a credit squeeze, not a financial crisis.

Yet debt and equity markets are both super-sensitive to perceived risk, affecting financing and constraining recovery.

The banks still want to reduce exposure to risk, and particularly to property, even at now much lower gearing levels. And the regulators are stress testing for another one-in-20-year event. That doesn't make sense. We've just had the one-in-20-year event, and the preconditions that caused it are gone. Meanwhile, for small business and property markets, rationing and high cost of funds is creating a substantial difficulty.

In equity markets, the flight to fixed interest is understandable - but not sensible - in behav-





The bigger risk is underinvestment, not overinvestment

journal terms, with no one wanting to stick their neck out and take a position.

Again, the GFC correction reduced market risk - it is now low, not high. The horse has bolted and they're shutting the stable door, effectively preventing it from coming back in. Gearing has come back to reasonable levels. Prices are no longer overvalued. And, with the collapse of development finance, the risk is of underinvestment, not overinvestment. Both debt and equity markets are misreading risk.

Some might argue that delaying recovery by constraining finance is, given the strength of the economy, a good thing. I would disagree. The current underinvestment, and the shortages that it will cause as demand recovers, is just setting us up for the next boom.

Meanwhile, the Australian economy has rebounded. Employment has grown strongly, boosting household income. Consumers have regained confidence but remain cautious on expenditure, careful about again letting go of the purse strings. They will spend more as the

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recovery proceeds. Private investment remains weak, but will now start to recover. The residential recovery has begun. Buoyant minerals prices and profitability have sustained mining incomes and expenditure, with the next round of minerals projects set to boost activity. Non-residential building will be slower to recover, with financial constraints, plus a hangover of the GFC-induced price correction, leaving prices below replacement cost levels. But solid demand in the face of

leasing market shortages will drive up rents and underwrite the next round of building. As public investment winds down, the private sector will take over as the engine of growth. The momentum of the Australian economic recovery will be underwritten by rolling investment cycles.

Meanwhile, the financial markets are still being driven by overseas conditions. Day-to-day movements in sharemarkets follow the US lead. Yet the prospects are quite different. In the press, and in commentary on the economy, fear rules. Fear of sovereign debt problems. Fear of a US double dip. How do those problems affect Australia? The answer is - very little. Australia is an Asian economy now. Exports into Asia are heading up towards 80 per cent of total. And Asia is strong. At some stage, both financial markets and economic commentary will have to disconnect from the US.

For Australia, the medium-term outlook is strong. We're looking at growth averaging 3.5 per cent over the next five years.

Our problems will be problems of prosperity rather than austerity. It won't be long before capacity and labour constraints in the face of solid demand lead to demand-inflationary pressure and tightening monetary policy. For asset markets currently underinvesting, that means tight supply, rising incomes and capital growth.

There are risks, but they come later. The next five years of solid growth are pretty much locked in.

To me, asset markets present an extraordinarily low-risk, high-return proposition. And my pick of markets is commercial property. I can't remember a time, not even at the depths of the 1990s recession, when property was a better prospect. ■

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