Australia's Economic Miracle - 28 Years Without a Recession!

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Australia’s Economic Miracle – Good Policy & Good Luck

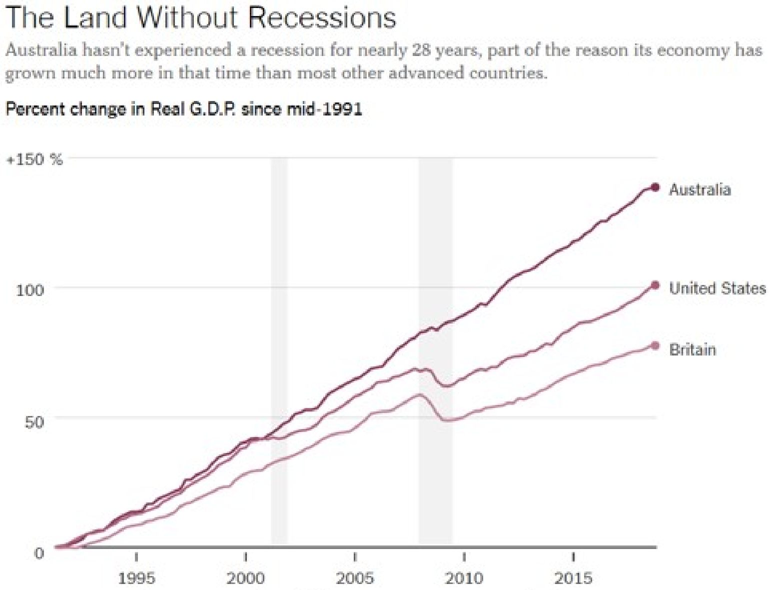
If the US economy remains in positive territory this month and next, as looks increasingly likely, this will be the longest economic recovery in America’s history. Expect a lot of celebrations just ahead. While that will be a true milestone, consider that Australia has not had a recession in almost 28 years! That’s what we’ll talk about today.

Ask Australian economists about this golden run, and almost all will say it has been driven partly by good policy and partly by good luck. The luck part can’t be minimized. Beneath the ground of large stretches of Australia are huge iron ore and coal deposits that have been the raw materials which have fueled China’s long economic boom.

Above ground lies the wheat and cattle that have helped feed China’s rapidly growing middle-class population. As Australia’s top trading partner, China’s meteoric economic growth has driven the Australian economy higher and higher.

China’s growth, in other words, has created a tailwind that has boosted Australia’s economy for much of the last three decades. And if the Chinese economy ever truly tanks, even the most skilled policymakers in Australia will have a hard time preventing a recession.

But China’s gravitational pull can explain only so much. For one thing, other countries nearby have had recessions, some severe, in recent decades. There is a long list of policy choices that enabled the long Australian boom even as otherwise similar economies had recessions.



Source: Australian Bureau of Statistics, Euro, BEA, New York Times

One episode is particularly telling. In 1997, an East Asian financial crisis tanked the economies of countries like South Korea, Thailand and Indonesia. These nations were major buyers of Australian exports. The value of the Australian dollar started to fall on global currency markets, putting the expansion at risk only six years in.

On the other side of the Tasman Sea, New Zealand's central bank responded to its falling currency by raising interest rates. Officials concluded that a falling New Zealand dollar indicated a lack of confidence in the currency and implied that inflation would soon rise.

At the Reserve Bank of Australia, by contrast, officials concluded that the falling value of the Australian dollar reflected shifting economic fundamentals that were ultimately healthy – and that the Australian economy could adapt to faltering demand from East Asia, they believed.

Rather than raise interest rates to try to prevent a falling currency, they viewed a falling currency as the key to navigating the peril – by making Australian exports more competitive in the United States and Europe, for example.

"The government was uncomfortable if the exchange rate went too low, because it looked like a sign of no confidence," said Malcolm Edey, who was the central bank's head of economic research at the time. ***"We had a good monetary framework in place, we stuck to it, and we didn't panic when the exchange rate moved around along the way."***

Sure enough, New Zealand fell into recession in 1997 and 1998, while Australia endured only a brief period of subpar growth. Good policy, it turns out, has a way of creating good luck. And it wasn't the only time.

Boring Economic Policy & Avoiding the Global Financial Crisis

If you had looked around the world in late 2006-2007, you would have seen a number of countries where housing prices had soared into potential bubble territory, including the United States, Britain and Australia.

But two years later, while the United States and Britain were in a severe recession and financial crisis, Australia experienced only a single quarter of contraction. Why the difference?

The answer seems to be how the financial industries of those countries were structured and regulated. After a wave of deregulation in the 1980s, Australian banks took on ever-more-risky lending, especially for commercial real estate. Yet they also diversified into new business lines overseas which would turn out to be an advantage.

When the asset bubble popped in late 2007-2008, many Australian banks came near failure, and there was a wholesale firing of top bank executives. Yet the overall economy suffered only one quarter of negative GDP growth before recovering. A recession is defined as two or more consecutive quarters of negative economic growth.

The banks – with prodding from regulators – restructured themselves to take a more conservative and domestically focused approach to lending. After that near-death experience, there remained the "Big Four" banks that together controlled about 80% of deposits.

The banks also did not engage in the kind of expansionist strategy that had gotten them in trouble in 1991. They did not open huge offices in Hong Kong, London or New York, nor get in the business of creating and selling the complex mortgage securities that were the nexus of the financial crisis in America and elsewhere.

Good regulation was also part of it. ***"They were good quality regulators; the public sector was getting good people,"*** Mr. Morgan said. Both major political parties have tended to be tough on banks, and there is a single powerful financial regulator rather than a patchwork of them as in the United States.

Another important point is the fact that Aussie banks focused on lending to Australians, especially for home mortgages, and held those loans on their own books. No doubt Australia has missed out on some opportunities by not hosting the big, complicated banks that operate worldwide and do more sophisticated forms of finance. Yet they avoided a recession.

By having a conservative, domestically focused, highly concentrated banking system, Australia wasn't stuck importing other countries' financial contagions when crises hit.

During the global financial crisis, Australia did suffer from plummeting demand for its products. But a nicely designed fiscal stimulus – combined with a falling Australian dollar and an assist from aggressive stimulus by China – helped the country regain its footing rapidly and avoid the mass economic pain found in so much of the world in late 2007-2008.

Despite 28 Years of Success, Australians Remain Cautious

If there's anyone you would expect to be bullish, it might be the young adults entering the Australian workforce, who have never lived through a recession. But among them – as with other Australians who don't occupy the halls of government or financial power – you find a surprising level of concern and uncertainty about the future, rather than boom-time optimism.

George Ye, 25, who is studying for a master's degree in data science at the University of Sydney, commented: ***"I think there will be a recession within the next 10 years. I feel like sentiment is, we might have gotten to a peak. Things have gone so well for so long that the things we need to buy are getting more and more expensive, especially housing."***

Freya Zemek, 24, an employee at the same university, warned: ***"I think we're probably looking at a recession in 2020. Consumer confidence isn't very high. The signs aren't looking great, and I think it's the sort of tightrope situation where we could be next for a recession. It's only a matter of time. Nothing goes on forever."***

The point is, Australian young people are not taking things for granted despite the country's unprecedented run of prosperity. That's probably a good thing.

One of the biggest concerns for the Australian economy is its sagging housing market. Housing especially seems to be in the opposite of a sweet spot. It's still too expensive, especially in booming Sydney and Melbourne, particularly for young people. Home prices are well below the peaks from a couple of years ago, as shown below, leaving recent buyers sitting on paper losses.

Source: Australian Bureau of Statistics, Case-Shiller 20-City Composite Index, New York Times

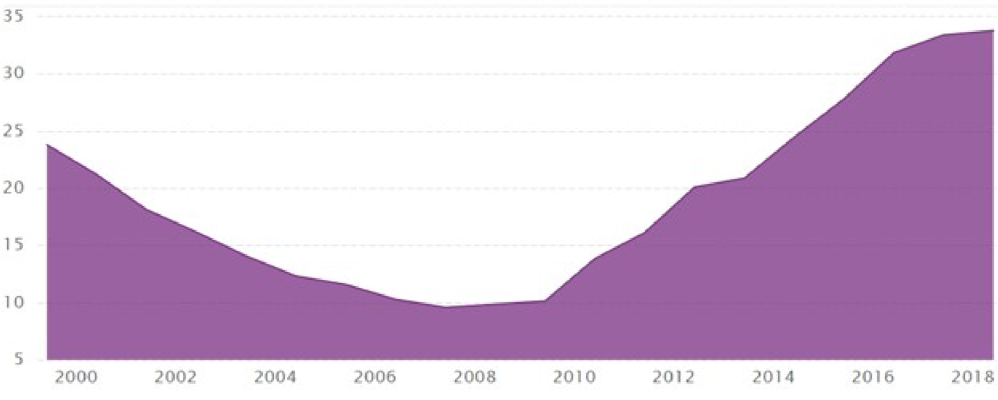
Conclusions – There's a Lot We Could Learn From Australia

It remains to be seen if the Australian economic miracle continues or if the first recession in almost 28 years is about to unfold. In the 4Q, Australia's GDP rose only 0.2% following 0.3% in the 3Q. For all of last year, GDP rose only 2.3%.

There is no question that some of Australia's success story has been a matter of luck – like having China as its #1 trading partner and having vast resources of iron ore and coal that China needs. China's growth over the last two decades has been phenomenal, and Australia has been a primary beneficiary.

Yet there is another important advantage that is not a matter of luck we could learn from. Unlike the US, Australia has been wise to keep its national debt under control. As you can see in the chart below, Australia has kept its Debt-to-GDP Ratio at reasonable levels, even though it has risen in recent years. Some analysts believe it will top 40% next year.

Australia Government Debt: % of GDP



Still, that's a far cry from the US debt-to-GDP ratio. Our $22.26 trillion in debt is **over 100%** of our GDP of apprx. $22 trillion. Unfortunately, there is no reason to believe our lawmakers, including the president, are the least bit concerned about our exploding national debt.

I could go on and on regarding this issue, but the main point is **there's a lot we could learn from Australia.** I'll leave it there for today.

Best regards,
Gary D. Halbert