Productivity Commission: Public Submission on Migrant Intake

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I believe Australia's economic model is flawed, unsustainable and ultimately deflationary: massive residential construction fed by high net migration and paid for by huge household debt – we are a classic example of what not to do.

Most other OECD countries have not followed this policy of high migration – why did we? To argue we will benefit from the demographics is so far proving to be a wrong assumption.

The property/debt bubble is a consequence of our high net migration, going from about 100.000 per year before the Olympic Games to about 300.000 in 2008/9. Current record median residential property prices are misleading – the credit-cycle and property bubbles are turning and a closer look shows *deflation* in some property markets has already taken hold in Australia.

High migration has only helped Big Business and Big Unions, leaving ordinary Australians to deal with the Big Mess.

At best we will avoid a credit crunch, but our standard of living and infrastructure will be second rate for decades to come.

Australia's mining boom delivered an *extra* $1.3 trillion dollars in revenue over 10 years and this has helped enable:

1. a boom in overseas student numbers looking for, and obtaining, permanent residency in Australia by simply completing a 2-year degree (now about 100.000 new students each year – a booming services industry)
2. which lead to a boom in housing construction to house them all (the equivalent of us building about an extra 50.000 dwellings a year more than other similar OECD countries)
3. which lead to a boom in the median-house-price in all capital cities where 80% of the population resides (because it's where most jobs are "crowded in")
4. which lead to massive investment and speculation in residential dwellings both by owner-occupiers and investors (thanks to negative gearing)
5. which lead to a boom in residential mortgage debt that now equals $1.5 trillion or 100% of GDP (much higher than in the U.S. or Europe).

Apparently Australia's high net overseas migration (NOM) policy of about 250.000 per year (which started around 2007) consists mainly of students, not skilled workers (they become "skilled" and permanent migrants after we train them at Uni for a fee – see a recent 4-Corners report). Forget mining, to understand Australia's economic model, follow the trail of students. It is not just "International Students" but also so called "Working Holiday Makers" – mostly young people who apparently can work and also *study* here. Now that mining is slowing, it's no surprise that we are actually relying on more overseas student-migrants and a further increase in residential construction to avoid a recession (in the last 12 months we lost over 50.000 jobs in mining and manufacturing but gained over 70.000 jobs in construction and real estate). An economy that relies heavily on residential construction is also very capital intensive and requires much debt. It's worked since 2007, but relying on migrants and residential construction is probably not a sustainable economic model. China's economy also relies heavily on residential construction, but they have at least borrowed from themselves to finance it, not from foreigners as we have, and as Spain did – that makes a big difference when it comes to the risk of credit contraction. I'm a mathematician not an economist, but our economy looks a lot like a ponzi-scheme to me, dependant on a constant stream of student-migrants and ever rising debt. The outcome will eventually be *real deflation* and a much lower standard of living for most Australians, compared to citizens of other OECD countries. (If you compare GDP Industry Gross Value Added for Mining + Manufacturing it's about the same in the U.S. and Australia at 14%, but Construction is 8% in Australia and currently only 3.6% in the U.S. after peaking at 5%. Residential construction and population growth has a huge multiplier effect on GDP-growth and that is why we have used very high migration for so long – unlike most other OECD countries).

Thanks to the mining boom, up until now, we could afford to attach a job, a dwelling and a mortgage to most degrees that our universities "sold" to overseas students in the last 10 years. Overseas students are happy to pay the very high Australian Uni-course fees with the promise of it leading to permanent residency for about 80% of students.

Two things remain unexplained for me, how are over 80% of all these students managing to attain a degree, and how can you get a masters degree in just 2 years?

I completed a five-year master of mathematics/science degree in Europe and only about 10% of students managed to complete the degree successfully. A recent Four Corners Report on Australian universities can explain the shameful difference.

Economies work in cycles (Ray Dalio, Howard Marks) with the credit cycle being the most important.

If you stop the high net overseas migration then a deep recession becomes highly probable. Keep the high NOM going and the debt bubble keeps getting bigger (our net external debt is now over 60% of GDP – risky borrowing from overseas is funding our growth). Despite the mining boom, our economy has relied heavily on debt.

The Reserve Bank argues that mortgage debt growth has now stabilised, only growing at about the same rate as nominal GDP. But that's like saying, due to our high population growth policy compared to other OECD countries, our nominal GDP has been growing much faster than others and therefore our debt can keep growing faster too. It's like saying, the larger your family is, the bigger your debt can be. The Reserve Bank is keen to argue that private debt may be high in Australia, but government debt is only 35% of GDP. In 2008 Spain's government debt to GDP was also just 36%, then with the recession it jumped to 70%. Ray Dalio, head of the world's largest hedge fund, explained the debt-cycle very simply last year, and every Australian should check it out. Basically he says, don't have income growing faster than productivity and don't have debt growing faster than income. In Australia real wages grew much faster than productivity and debt has grown faster than income. We are a classic example of what not to do. Since 2005 nominal GDP and total wages have grown by 6% p.a. (thanks to much higher real wage growth than in other OECD countries) and debt has grown by 6% p.a. – while productivity was flat and infrastructure spending was almost non-existent, hence the low government debt.

The U.S. subprime crisis showed, even a relatively small number of indebted households can produce considerable turmoil, as Timothy Geithner writes in his book Stress Test on page 112: "subprime was only one-seventh of the mortgage market, barely $1 trillion out of the nation's $55 trillion in financial assets". But as he writes, it's the attendant contraction in credit, the liquidity crunch that causes the shock to the system and sends unemployment numbers spiralling higher (in Spain it reached 20%).

Australia's housing has morphed into a highly indebted investor's market thanks to negative gearing; investor mortgage debt alone is now a staggering $500 billion. What could cause a financial panic? A liquidity crunch could develop here if foreign creditors become spooked. What happens when the debt cycle turns?

(An owner-occupier will not sell if his home falls into negative equity, unless he is forced out, because he needs somewhere to live. It's a much different situation when it comes to negative geared investment property – if there is a risk my $800.000 investment property could fall in value by 25% (the RBA's stress scenario), that's a potential loss of $200.000 – I'm probably going to try to sell fast, especially if I've borrowed a lot of the money, and even if the tenant is still paying his rent. But what if I only paid $600.000 for the investment property and I have no mortgage debt? Seeing the value fall from $800.000 back to $600.000 may not bother me, but then what happens if rents start falling and the value of the property falls even below $600.000? Similar to shares on the stock market, these investment properties are generally retirement nest-eggs and if residential real estate investments suddenly appear to be risky, selling will be on everyone's mind, not just those with debt. If rental income becomes less certain, and I can get maybe $500.000 if I sell now, then the cash will be a much safer option for my retirement than an uncertain rental income. Before you know it, properties that sold for $800.000 are soon selling for $500.000, and a lot of people who borrowed would be looking at negative equity. Even if there is no major fall in dwelling prices, over time these investments will probably prove to be very poor and illiquid).

Potential triggers for a liquidity crunch and financial crisis in Australia:

1. House Prices: The first sign of trouble will be when the median house price starts to fall. House prices in America started to fall in 2006 and within 2 years there was a crash. The median-house-prices in all capital cities of Australia have reached record levels, with Sydney's median house price now reaching a staggering $1M. Australia's urbanisation is very high, 80% of the population live in a capital city, so these changes affected many people. The wealth effect was tremendous, not only were total real wages growing much faster than in other OECD countries, but so were rents and the value of dwellings. This was a huge windfall for all property owners.

Higher mining revenues, higher wages, lower taxes, higher migration, higher debt levels, much reduced infrastructure spending..... absolutely everything was thrown at the housing boom (especially high NOM). All these props now need to be kept in place just to keep the median-house-price from falling. Remove just one prop and the whole thing could collapse, because investors are also speculators, and speculators can become pessimistic very quickly as extreme stock market volatility has shown. What happens to house prices if Australian banks start asking for a 40% equity down-payment before offering a home loan (as banks in some countries in Europe are now required to do)?

2. Unemployment: The second sign of trouble is unemployment. We can not maintain high levels of net migration if there are no jobs available now that mining revenues are falling. Having worked in Europe I find our wages are not competitive and sometimes our work- ethic here is based on "lifestyle first and the job second". It's the other way around in many countries. A "she'll be right" attitude is fine but it's hard to compete in this world with that approach.

3. Debt: Australia's AAA-rating has already been put on watch.

Australia is now a country with very high investor mortgage debt due to our negative-gearing tax incentives. Comparing our house prices with New York or London is meaningless because, as opposed to Australia, firstly, only a very small percentage of these countries' total populations live in expensive cities like NY, LA or London, and secondly, the high proportion of rental real estate in these international cities is mostly owned by wealthy people, as opposed to Australia where investors tend to be, not rich, but middle-income earners trying to reduce taxes through negative gearing.

The 2013 "Eurosystem Household Finance and Consumption Survey" found that more than half of all euro area households have no debt, the rest have on average very little debt. In stark contrast the ABS paper on Households 2010 (5204.0.55.009) showed that 65% of all household loan liabilities in Australia are found in the 2nd, 3rd, and 4th quintile of household incomes (with 30% in the highest). That means that the "middle" 60% of Australian households owe 65% of the current $1.570 trillion in household liabilities. That's an average debt of about $168.000 for each of those 5.6 million households (out of a total of 9.4 million). The RBA however, prefers to use the debt-to-GDP ratio because it looks better than the absolute numbers (again, thanks to our high population growth, nominal GDP is now about double what it was in 2003). But that is a trick that can backfire badly once unemployment rises and a recession leads to a lower GDP and quickly rising debt ratio. Yes, other countries may also have high debt-to-GDP ratios but often that debt turns out to be government debt that was used for beneficial and much needed infrastructure, something Australia has now yet to build (if ever).

4. Falling Rents: In US-dollars our GDP per capita is now about the same as in the U.S. but when it comes to rent the US Department of Numbers has the median gross rent in the U.S. at only AUS$270/week (with only 5% of Americans living in expensive cities like NY and LA). The median rent in our capital cities, where most people reside, is about AUS$700/week! High rents and mortgage repayments are a huge strain on our economy. The Austrian financial paper Wirtschaftsblatt recently wrote that in Vienna, a city of 2 million, despite a recent 50% increase in house prices (off very low prices for years), it is becoming difficult to find anyone prepared to pay more than $330 a week rent (1000Euro/month), with most renters only prepared to pay between 400Euro to 700Euro a month. Austria's GPD per capita is equal to ours, yet it costs less than half to rent in their capital city than it does in any Australian capital city. Are our rents sustainable?

5. Consumer Spending may slow: Just after the second world war, when my parents migrated from Austria to Australia, Australia's and Austria's population were both about the same, 8 million. Now our population is three times that at 23.7 million and Austria's is still only about 8.6 million. Austria's per capita GDP and standard of living (on a PPP comparison) has caught up and is now even better than ours – and they didn't even have a trillion dollar mining boom! Tripling the population did us generally no good. Voters may soon realize that high NOM on the basis of demographics is simply an agenda that suited big business and powerful unions. According to the RBA Australia's household debt to disposable income is a staggering 150% (oddly the ABS has it at 180%) – and we tripled the number of households!

6. Public Debt and the Social Fabric: The rise in population and house prices encouraged ever more funds to be diverted away from badly needed infrastructure (including entertainment options) into larger and unproductive residential property investments. Income taxes were systematically reduced to win votes. Trouble could come if the government eventually needs to reverse this. Spain's public debt jumped rapidly from 40% of GDP to 70% once their recession hit. Poor infrastructure also means a lower standard of living. Spain has trains that travel at 300km/hr, while it still takes 90mins to travel the 70km from the City of Gosford to Sydney by train, like it did a hundred years ago (and much longer from Newcastle). Better still, try that trip by car. Spain has had high speed trains for over a decade while all we have done here is talk about it for decades. Yes, the average floor area of an Australian home is about double that of other OECD countries, but commuting has become a joke, and there's nowhere to go anyway, so most people just stay at home, while young people just get drunk or on drugs. There is no social fabric with over 30% of the population born overseas, and another 30% with a migrant background. State and local governments have limited resources to offer entertainment due to budget constraints, so that leaves pubs and clubs. But pubs and clubs drain communities of revenues through the pokies and are unattractive venues for many migrants. Take for example The Entrance on the Central Coast which has three very large clubs that I believe take-in collectively almost $1-million *a week* on gaming profits – money that would be better spent by a happy thriving community in lots of top restaurants and shops along the foreshore, also attracting many tourists, and with old and young people mixing (like in other countries). Instead you see segregated, many over-30s, unhappy-looking people playing the club-pokies, while the younger people get drunk at the pubs (away from the "oldies"); meantime the foreshore/town is dead and tourism has been weak for decades (ever since the clubs expanded exponentially). If you want to bring in lots of migrants it takes time to develop a decent shared cultural mentality and community spirit. At this stage I can't see it. It's up to governments to rectify these things but it takes money and time. Simply spending millions, once a year, on NYE-fireworks is not community-building. Neither is glorifying war every year with Anzacs – something probably only a minority of Australians can really relate to (how many Aussies know that WW1 mobilized 65 million troops, claimed 20 million military and civilian deaths, and 20 million wounded? – Clark 'The Sleepwalkers'; Australia had 420.000 enlisted and 60.000 died). Every country had heroes, not just Australia, but most don't celebrate war. I don't think many migrants are really very happy in Australia and that's why so many travel overseas whenever they can. Pubs and clubs are a novelty at first but that wares off. Pokie-state-tax revenues drain the communities, but staff working at these pubs and clubs fiercely defend their high wages, so politics will not change anything soon. I'm personally disappointed with Australia. Politicians have dropped the ball on both sides. As a 26-year old, returning from studies in Europe, I might have found Australia refreshingly easy-going, wild and carefree, but now at 60 I find it boring, mismanaged and sometimes even dangerous. It seems gambling mostly, keeps people entertained. "Original" Australians wear a singlet and thongs on an international flight, pyjamas to the Opera House and high-heals or a suit to a muddy horse race..... go figure. Australia is surely going through a difficult transition. When it comes to health care, education and law enforcement I believe we do not have world's best practice, no matter what Alan Jones or Ray Hadley might shout at "their listeners". In fact NSW ex-police commissioner Peter Ryan wrote in his book The Inside Story in 2002 that the future of democracy was at risk in a country where a radio host can call the shots for a government. It seems that in a fragmented society of 24 million people like Australia, even a relatively small group of perhaps 400.000 "listeners", followers of the guru, can have the biggest influence on a country's future. What developed country other than Australia still uses demountable classrooms (and that's with half the schools being funded privately)? We have a huge drug and alcohol problem that's gotten only worse in the last 30 years. Judges keep releasing repeat-offenders of crime simply because we don't have the infrastructure, the prisons to lock them up. We can't afford to put power lines underground so we keep suffering storms with blackouts (sometimes for days, like recently again for over 200.000 people around Sydney). High migration has given us quantity but not quality of life. Fewer migrants, smaller homes, lower debt, much better infrastructure and happier, less frustrated people...... that's what clever planning would have produced during the last 12 years of our mining boom. That's my opinion.

7. Overvalued currency and low Interest Rates will lead to Deflation: Billionaire Stanley Druckenmiller recently explained at a charity talk, how too loose monetary policy (used as an insurance policy to avoid a recession) can lead to an *inflated average household net worth*, which can lead to unintended consequences, such as a bust and deflation. Australia currently has about the highest household net worth in the world. He also explained how first Japan, and now Europe, have had overvalued currencies for years, which "hollowed out" their countries, and is deflationary. He says it takes years to unwind the dislocations caused by an overvalued currency. Australia has had one of the most overvalued currencies for years now. So Australia had both an overvalued currency and inflated household wealth, a recipe for real deflation in the future. It has in fact already started; dwellings worth over $3-million in our major cities and homes over $2-million outside major cities are already very hard to sell (*baby-boomers* are downsizing with no one able to buy their larger properties). While median prices might be rising, more expensive properties are selling at a discount to values achieved just a few years ago. The hype about record median house prices is masking the reality – deflation has already begun. There is already no hope for future capital gains in more expensive dwellings and buyers have already vanished from this part of the market. Lower interest rates make no difference now.

8. Mining revenues - Ignoring the experts: Prominent and highly influential shock-jocks, vested interests, members of the Board of the Reserve Bank and Politian's have all been vigorously **"talking-up the market"** for years in relation to housing and mining, while dismissing warnings from experts like Professor Ross Garnaut and Lindsay David (described by one shock-jock as "idiots"). Various government departments (starved of funding, perhaps purposely) were bringing out reports which simply relied on estimates supplied by big business (for example the crazy projection that China would be producing one billion tons of steel annually by 2020). If it is un-Australian to be negative about the economy, then we are living in a fool's paradise. Many politicians and talk-back radio personalities are heavily invested in real estate, so they have an interest in keeping NOM high and dwelling supplies low. But it's a dead end.

As far as I can tell, in 2015 around 130.000 overseas students will be arriving but only about 25.000 students will be leaving. Every year, after completing a minimum 2-year degree, around 100.000 overseas students remain in Australia, on a temporary post-study work visa and eventually a permanent skilled migrant visa. A student can complete a *one year* Bachelor degree followed by a *one year* Masters degree, to meet the requirement under the Post-Study Work stream. Apart from the expensive tuition course-fees, students must demonstrate they have funds of about $20.000 per year to finance their living expenses while a student (and they can also bring family members). To find a job there are government departments like JobSearch and the very long Skilled Occupation List.

Thanks to the mining boom we could afford to supply these student-migrants with many new jobs in areas such as health care, and they in turn supplied us with many residential construction jobs to house the huge increase in population. Joe Hockey admitted, high immigration is a lazy way to try to grow the economy, but both the Business Council of Australia and the Unions love it (the CFMEU just scored another 15% pay rise over 3 years for their building union). Big business and unions are making the most of it while things last. Ever wondered why other countries didn't do the same?

For the capital cities of Australia, building and selling units to migrants became the biggest game in town, housing on steroids (just look at the 50-storey unit-towers in Brisbane growing like mushrooms). There were alone over 500.000 new health care jobs created in the last 10 years, and in that time, Sydney required the equivalent of constructing about 1300 new 25-storey residential towers to house all the new migrants to Sydney. High migration probably added at least 1%pa to our real GDP.

This juicing of the system is still ongoing, with the government seemingly unperturbed by any possible consequences – well of course they have no choice now. Subprime in the U.S. was about granting home loans to people who did not have the income to repay the debt. Overseas students who obtain permanent residency in Australia and take out a home loan, will suffer the same demise if the jobs we offer them are not as secure as they had hoped. Only time will tell, but it looks a lot like a ponzi-scheme to me, and one that's gone on for many years. It will be very interesting to see how this credit-cycle ends. I cannot see how an extra 200.000+ permanent migrants each year is going to make things better for the majority of those already living here..... except maybe, to keep the bubble going a little longer.

Regards

Alex Finch