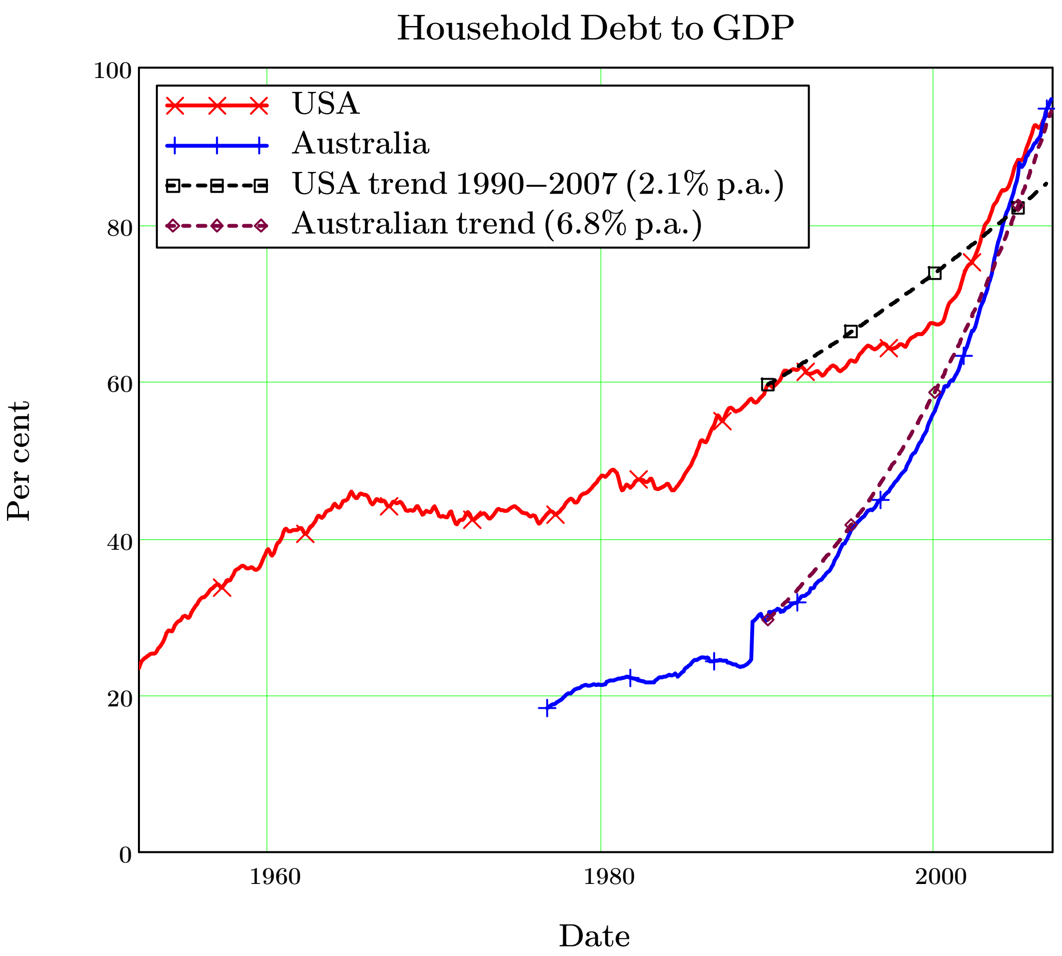
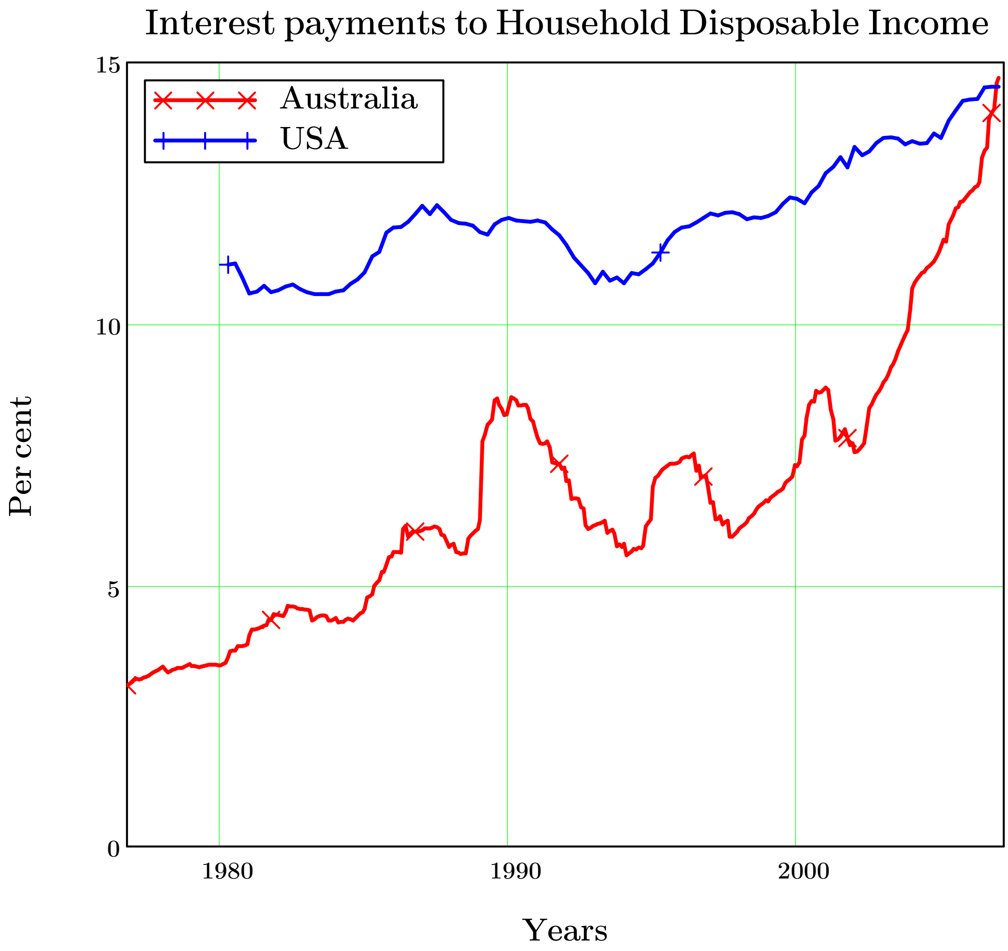
Who's having a housing crisis then?

Global economic attention has been focused on the sub-prime lending crisis in the United States recently, and many local analysts have made soothing noises to reassure Australians that "it couldn't happen here".

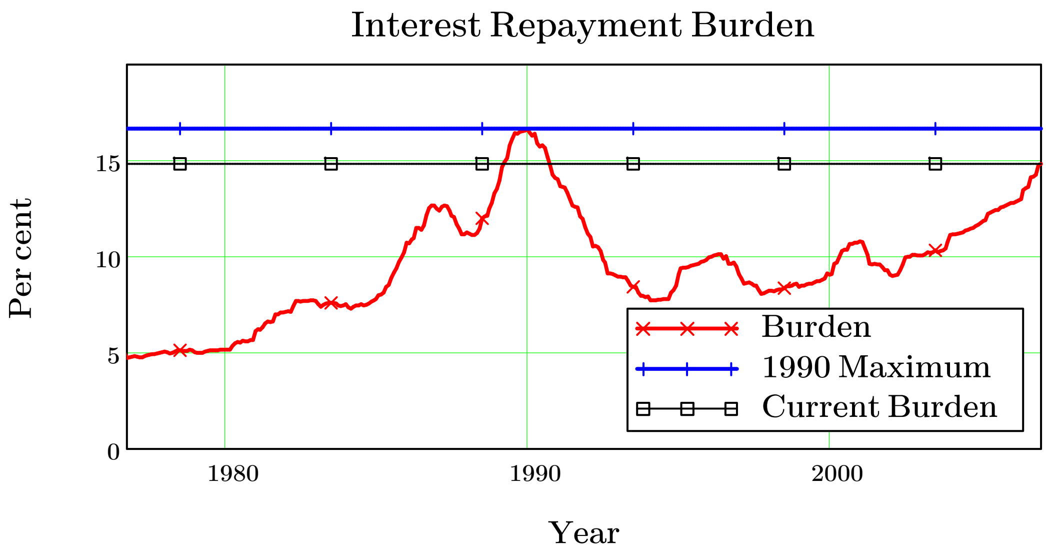
The USA's sub-prime market is indeed a peculiarly American phenomenon; but the level of Australian household debt (the sum of mortgage debt and personal debt) is every bit as extreme as the USA's. And contrary to popular opinion, our debt binge dwarfs America's. As the chart below shows, Australia's household debt to GDP ratio has been growing more than three times as rapidly as the USA's since 1990. The ratio has grown at an average of just over 2% per annum in the USA; it has grown at over 6.8% per annum here.



As a result, while Australian households carried less than half the debt that Americans did in 1990 (21% versus 48% of GDP), now they are burdened by even more debt: 96% of GDP in early 2007, versus 94% in mid-2006 (the American data reporting cycle lags ours). Since Australian interest rates are higher than America's, the debt burden on households is actually higher here. America has experienced a lending crisis because the quality of borrowers at the tail of the US credit system is lower than at the tail of ours. But the aggregate figures give absolutely no reason for Antipodean complacency.

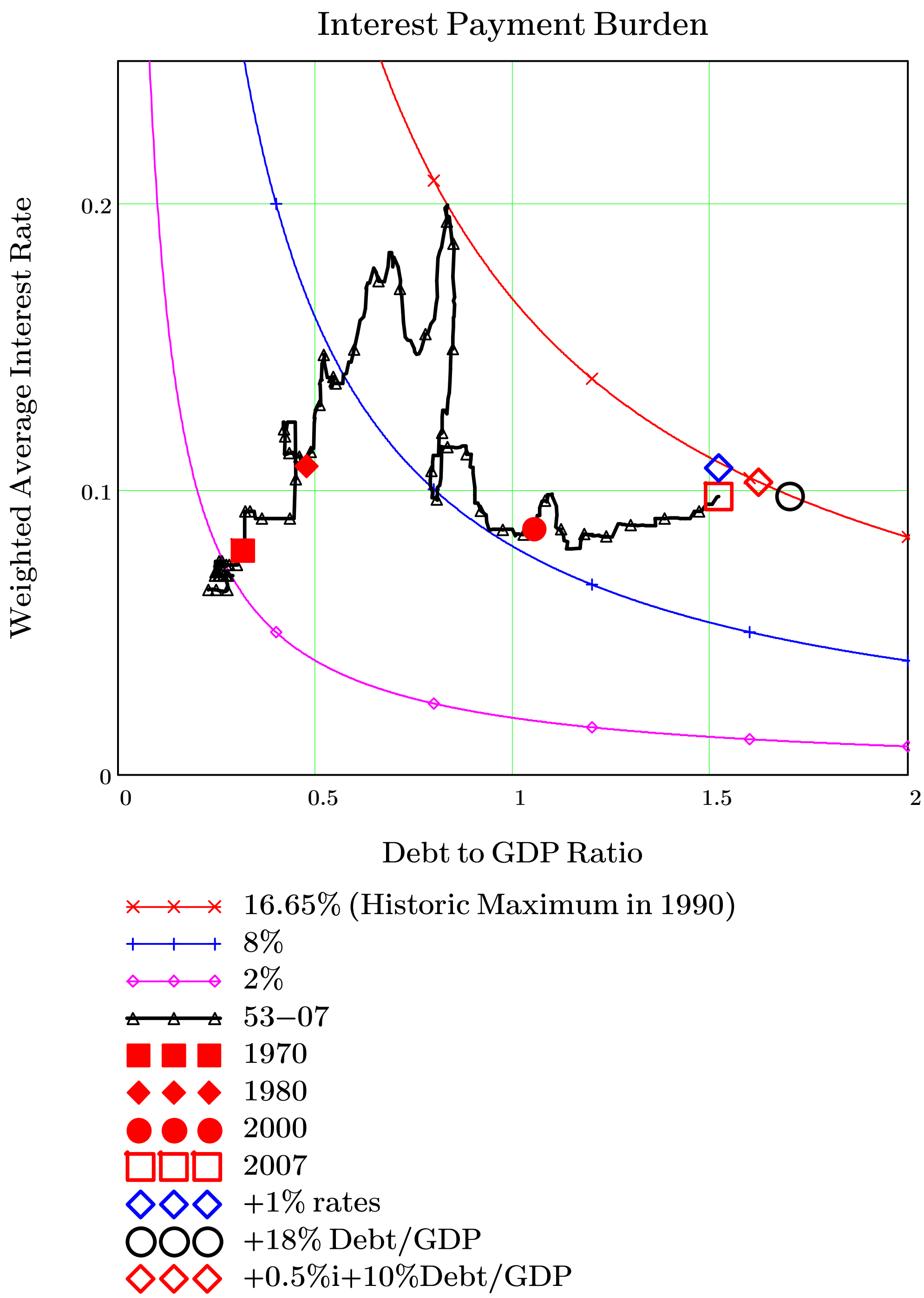


We are also within reach of an Australian historical watershed: the increase in debt since 1990 has been so great that interest repayment now takes up more of GDP than at any time since mid-1990.



A one per cent rise in rates, or an 18 per cent rise in the debt to GDP ratio, would put us at the same repayment burden level that ushered in "the recession we had to have".

Those two hypotheticals might both seem unlikely. But a half a per cent rise in rates is possible if the RBA persists in trying to "fight inflation" by raising interest rates; and on the most recent trend, the debt to GDP ratio will be ten per cent higher than today by the beginning of 2008. That combination would also take us to the same pain level as in 1990.



Should the RBA increase rates?

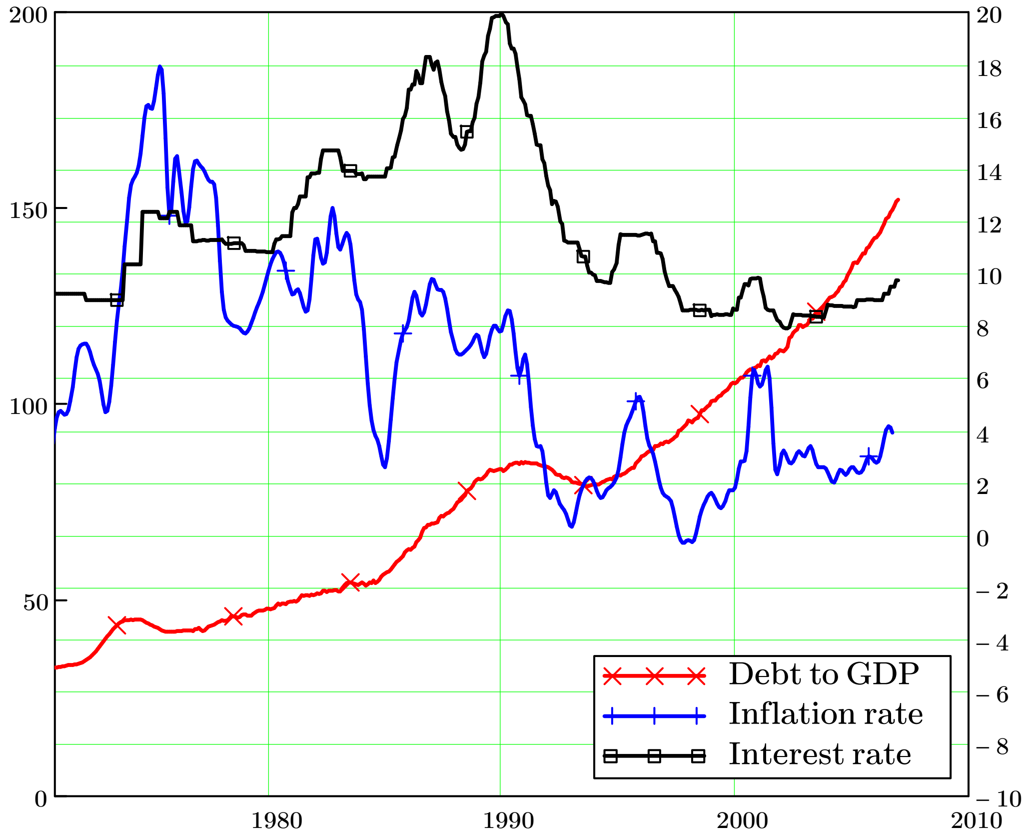
Especially after Dr Edey **recent speech**, there has been strong speculation that the RBA would increase rates soon, with the objective of "fine-tuning" the rate of inflation.

In these circumstances, raising interest rates to control inflation would simply accelerate an aiready unsustainable trend of debt accumulation--since one impact of a 1/4% rise in rates is to increase the rate of growth of debt.

The RBA's economic models do not take the debt to GDP ratio into account (see RBA Research Discussion Papers 2005-11 and 2007-01). The level of private debt was also about th only economic statistic ***not*** mentioned by Dr Edey in his However, it is obvious that the impact of a rate rise is proportional to the level of debt--after all, this is why the RBA moves rates in 1/4% increments now, compared to the 1% steps it took in the 1980s--when the private debt ratio was less than a third of what it is now.

Given that debt amplifies the impact of a rate change, and that debt service ratios are already within reach of levels that have induced recessions in the past, the impact of the rate rise on the economy may be far more deflationary than the RBA's modelling anticipates.

I therefore cannot concur with the RBA's overall assessment that "in aggregate, the household sector is coping well with the higher levels of debt and interest servicing" and "Overall, the household sector remains in good financial shape" (RBA FInancial Stability Review 0307, pp. 16, 17). Given that debt servicing levels are approaching record levels, putting up rates now in order to control inflation could amount to "hitting the brakes wearing lead shoes".



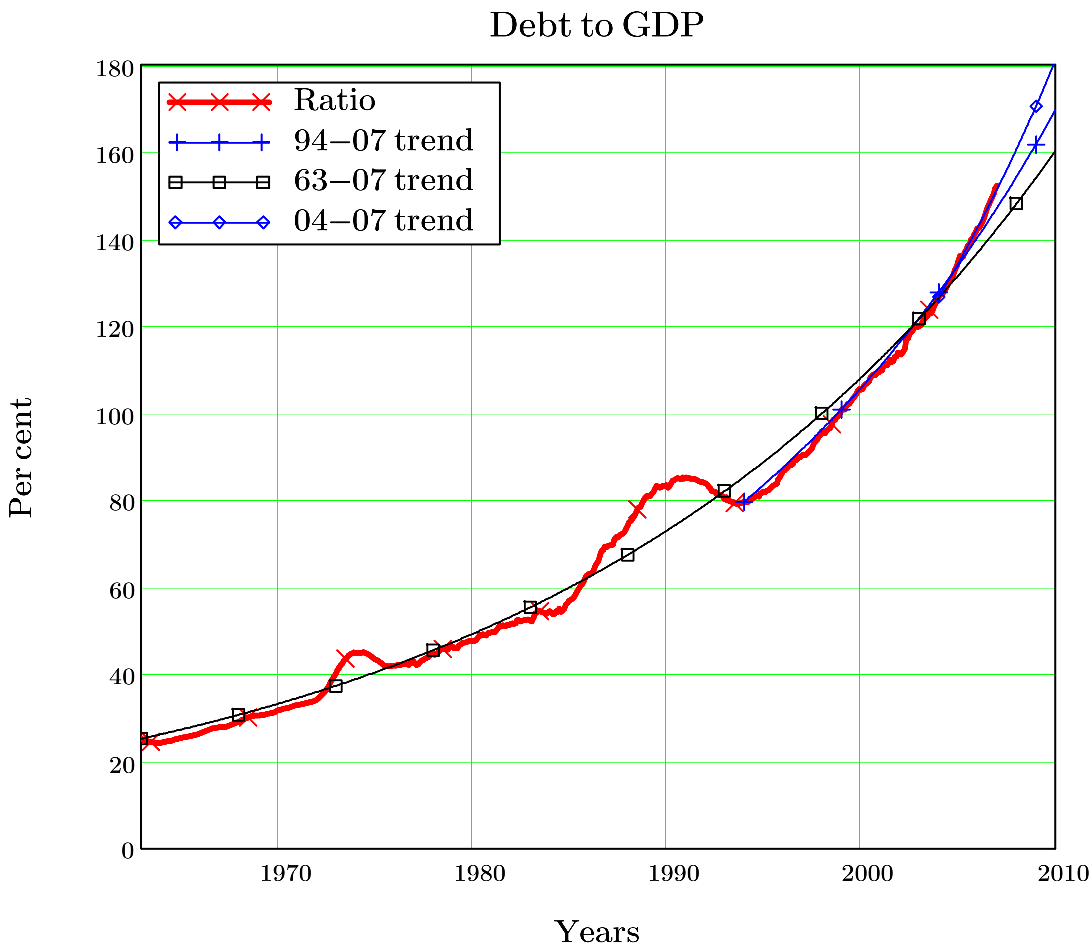
This is clearly what happened in 1990, when a very similar debt burden brought the economy quickly to its knees. Inflation dropped precipitously (along with everything else), from 8 per cent to virtually zero, and the RBA was forced to drop rates even more.

I have heard some market economists saying that an additional reason to put rates up now is that it might help discourage borrowing. This hope ignores the time lags that abound in our monetary economy--and a quick look at history would make that obvious. Rates peaked at 19.95% in 1990, and the economy rapidly fell into a recession--but the debt to GDP ratio continued to climb for another year.

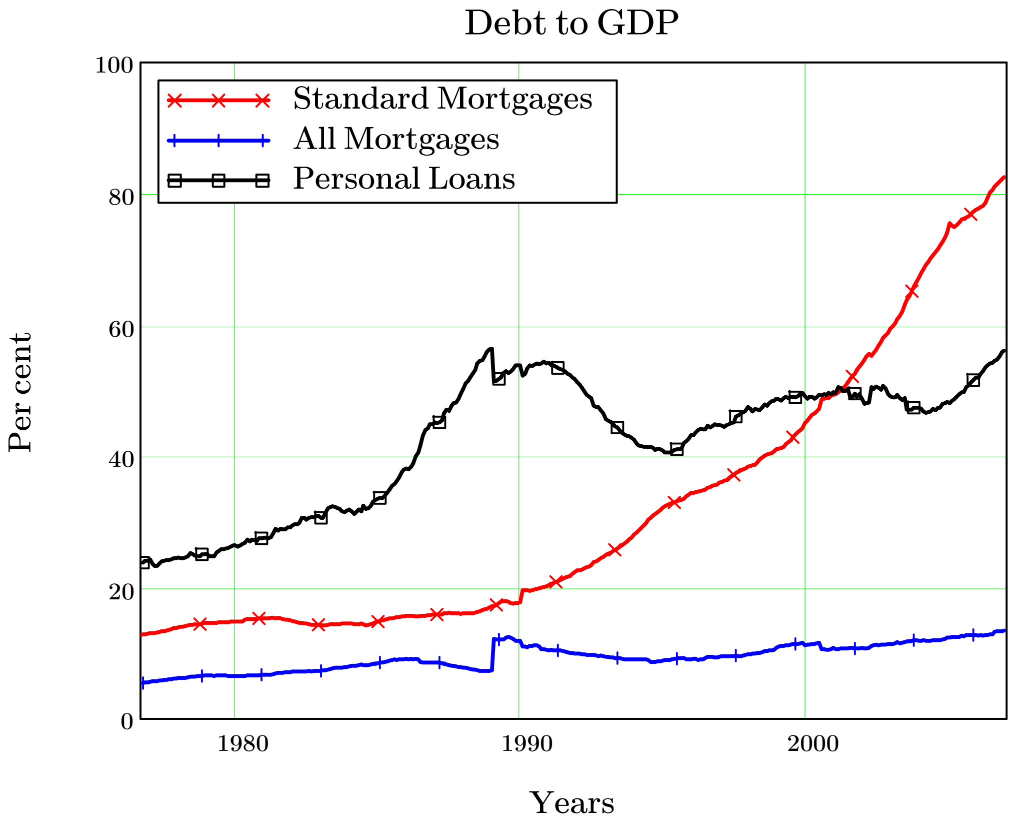
The reason is simple: when you can't afford to service your debts, they rise more rapidly because the missed payments are added to the debt. Putting rates up now would simply make that problem worse.

Sustaining the unsustainable

The debt to GDP ratio continues its seemingly inexorable rise, and is now at 152 per cent of GDP. The rate of growth is above the long term trend. If it continues, the ratio will reach 160 per cent of GDP by the beginning of 2008 (this is the level that applies in the USA now).

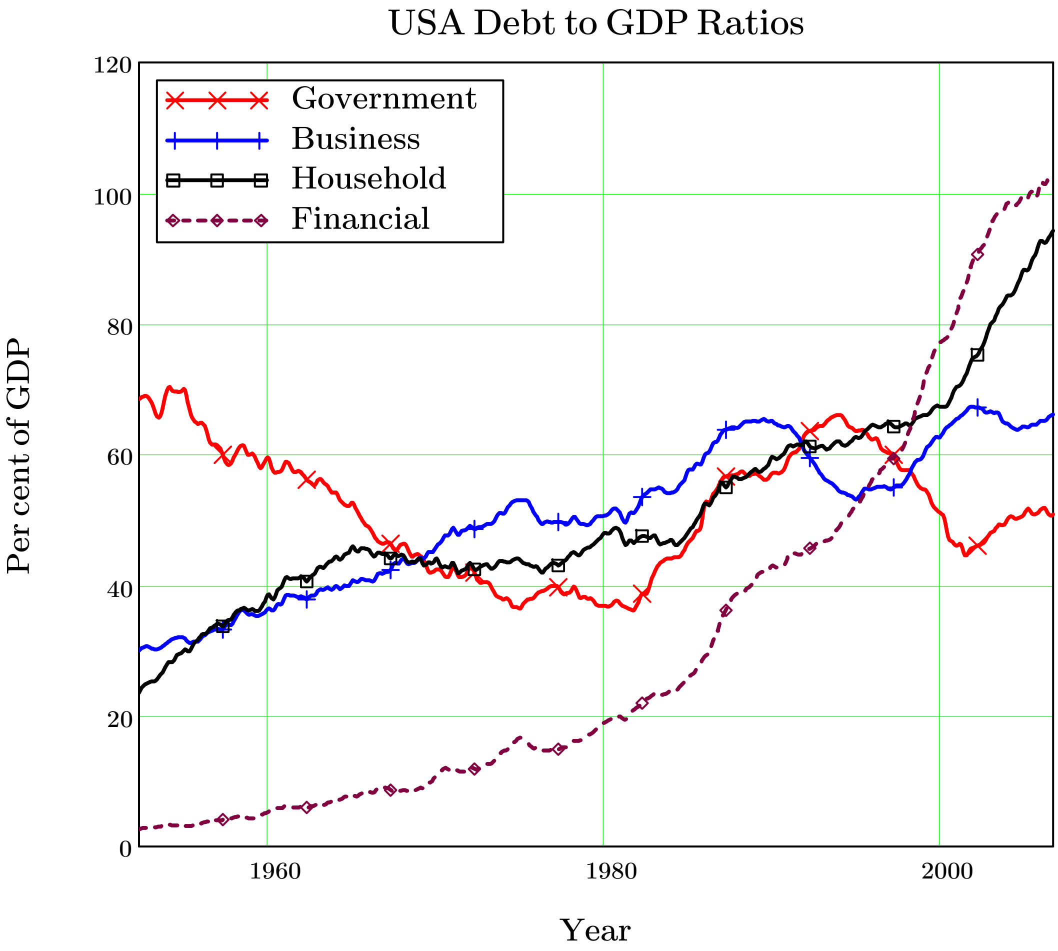


All private debt ratios rose last month. All except the business ratio are at historic highs, and with the business ratio now at 56.36%, won't be long before it cracks the 1989 record of 56.39% of GDP.

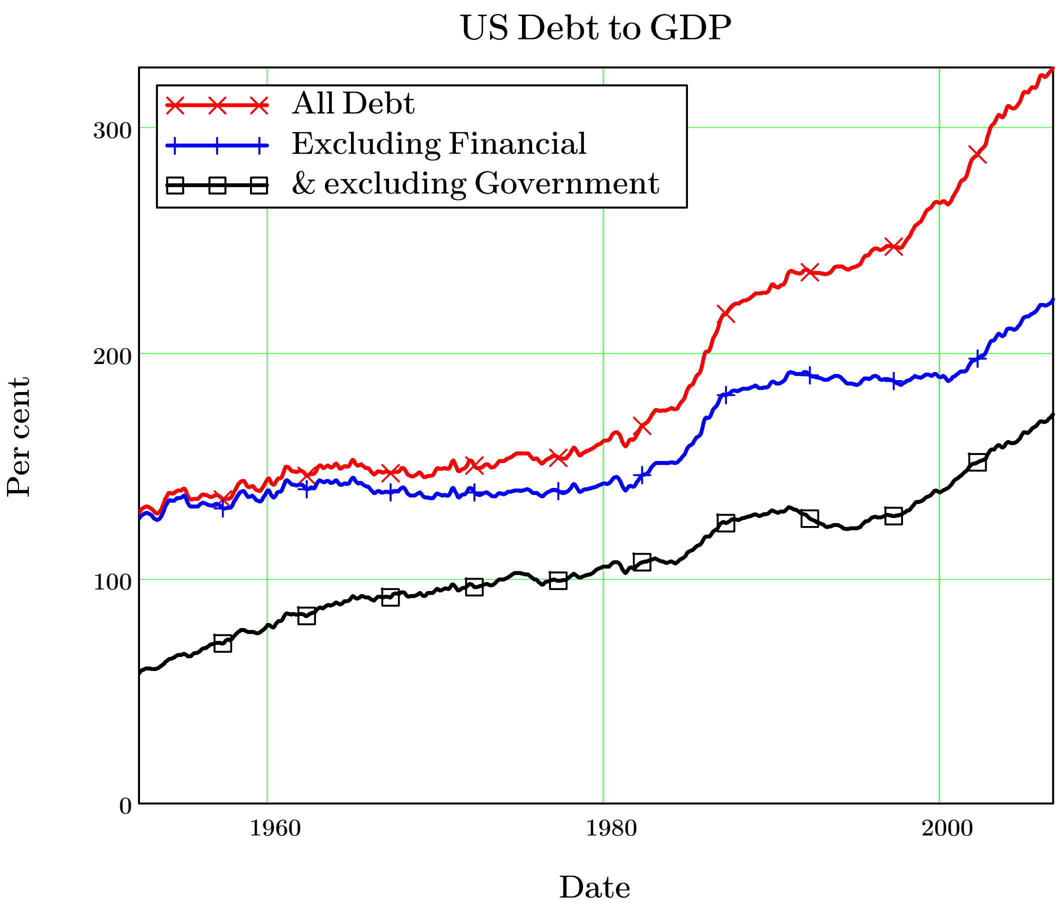


America: Home of the Brave, Land of the Leveraged

The one way in which the USA is different from Australia is that every component of American society is in debt: not just households and businesses, but government as well. This may become an important distinction if a debt-deflation occurs: the USA will begin the process with substantial government debt, whereas the Australian government will start from a fiscally neutral position.



The aggregate level of debt in the USA, at over 320% of GDP, is staggering--especially since this does not factor in the "off-balance sheet" activities of the derivatives market.



I can't do better as a commentary on this situation than to quote a **recent editorial** from the New York Times:

> Investors who fail to take a hard look at the vulnerability of the American economy are courting tremendous risk. The fact that after years of profligacy the federal government is fiscally ill prepared to respond to a destabilizing downturn only increases those risks. **New York Times** "**Unwary Investors**" (March 24 2007)

In contrast, one positive side effect of the Australian obsession with eliminating the government debt is that our government is fiscally well prepared to respond to a private debt crisis, should one ultimately occur. Whether it is intellectually prepared is another matter altogether.

Data Sources

RBA Bulletin Statistical Tables: http://www.rba.gov.au/Statistics/Bulletin/index.html
US Federal Reserve Board http://www.federalreserve.gov/releases/z1/Current/data.htm