Steve Keen's Debtwatch May 2007

Booming on Borrowed Money

It goes without saying that I'm a Cassandra amongst the Pollyannas crowing about Australia's current economic performance data. Low inflation, low unemployment, and no sign of a wages breakout, are the usually-quoted sweet economic indicators (admittedly with some strange bedfellows, including a relatively slow rate of economic growth for these conditions, and a huge balance of trade deficit despite the best terms of trade in history).

So how do I justify the stance of a Cassandra? Because things can't continue as normal, when normal involves an unsustainable trend in debt. At some point, there has to be a break--though timing when that break will occur is next to impossible, especially so when it depends in part on individual decisions to borrow.

However, it is possible to quantify the minimum impact that the end of the unsustainable might have on the economy: what would happen to aggregate spending if private debt grew no faster than GDP?

Aggregate spending--on both commodities and assets--is the sum of incomes plus the increase in debt. Using GDP as the measure of income, this was $1,001 billion in the last calendar year. Over the same period, private debt increased by $202 billion. Aggregate spending was thus approximately $1,200 billion.

Private debt grew by 14.9 per cent in the last year, versus a 7.4 per cent growth in nominal GDP. If both private debt and nominal GDP were to grow at the same rate as GDP last year, then GDP next year would be $1,075 billion, while debt would rise by $115 billion.

Aggregate spending would thus be $1,190 billion--or $10 billion ***less*** than spending this calendar year. In one sense, we are now so much in debt that we can't afford not to continue borrowing. And yet the more we do borrow, the more severe the shock will be to aggregate demand when the correction finally occurs.

This situation has come about because of the exponential growth in debt relative to GDP. Back in 1963, when debt was just 25 per cent of GDP, a fall in the rate of growth of debt had only a minor impact on demand. Now, with debt equivalent to 153 per cent, that small effect has become a very big one.

So my Cassandric pessimism is not entirely based simply on disposition. At some point, the debt to GDP ratio must stabilise--and on past trends, it won't stop simply at stabilising. When that inevitable reversal of the unsustainable occurs, we will have a recession.

Just the Facts, Ma'am...

$D_1 =$

	0	1	2
0	"Summary"	"All"	"Nominal GDP"
1	"Levels ($m)"	1555197	1001945
2	"Change in last year $m"	201521	69246
3	"Change in last year %"	14.89	7.42
4	"Since 1990"	8.45	5.35
5	"Since 1980"	11.97	7.95
6	"Since 1963"	13.29	9.44
7	"% GDP"	153.52	100
8	"Growth rate"	7.17	"N/A"
9	"Since 1990"	2.84	"N/A"
10	"Since 1980"	4.09	"N/A"
11	"Since 1963"	3.94	"N/A"

$D_2 =$

	0	1	2	3
0	"Detail"	"Business"	"Mortgage."	"Personal"
1	"Levels ($m)"	580471	837444	137281
2	"Change $m"	84305	100447	16769
3	"Change %"	16.99	13.63	13.91
4	"Since 1990"	4.73	14.74	5.27
5	"Since 1980"	10.62	14.03	10.44
6	"Since 1976"	11.17	14.31	11.24
7	"% GDP"	57.31	82.68	13.55
8	"Growth rate"	9.16	6.02	6.29
9	"Since 1990"	-0.91	9.31	-0.52
10	"Since 1980"	3.02	5.99	2.61
11	"Since 1976"	3.09	5.75	2.99

Charts of the Month

This month's charts focus on the role of the growth of debt in demand. Chart 1 divides the annual change in debt by the sum of GDP and the annual change in debt--thus indicating the contribution of debt alone to aggregate demand. This has risen from less than 5 per cent during the '60s to over 15 per cent in the last four years--a higher level than applied even during the worst excesses of the 1980s boom, because aggregate debt is twice as high now (relative to GDP).

The peaks and troughs of this data series provide an interesting debt-focused commentary on Australia's recent economic history. The first major peak (of 11.5 per cent) occurred in late 1972--just before the election of the Whitlam government, and long before the OPEC price rise that most commentators believe ushered in the economic turmoil of 1973.

Equally interesting is the peak in the 1980s of 15.5 per cent. This occurred in November 1987--the month after the Black Monday Stock Market Crash in October 1987. Though the stock bubble rapidly gave way to one in real estate (primarily commercial property), change in debt was on a negative trajectory almost from that day. By the start of "the recession we have to have", debt was growing no faster than GDP, and in the depths of the recession in mid-1991, change in debt was reducing aggregate demand by one and a half per cent.

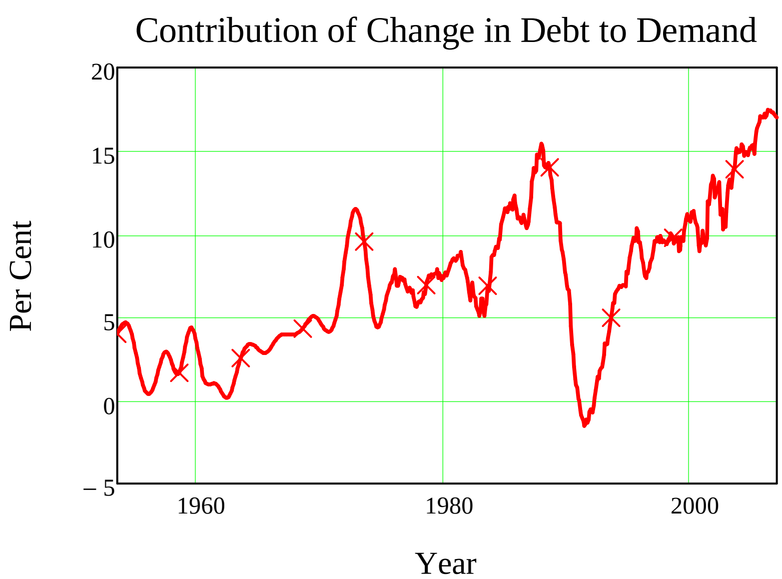
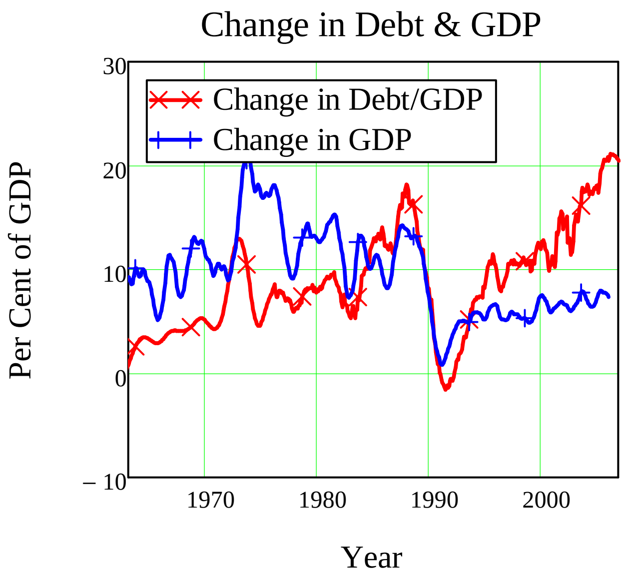


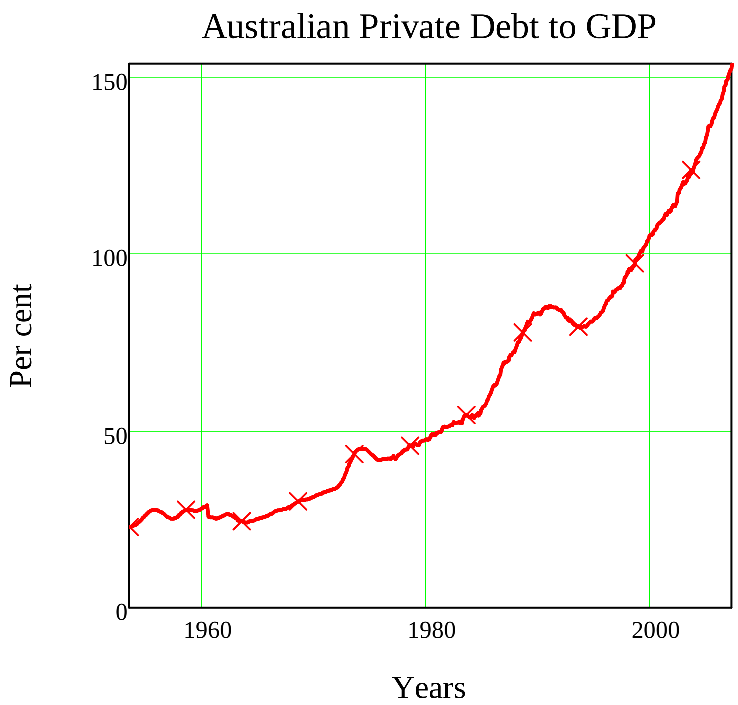
Chart 2 shows what a cross-over experience the 1990s recession was. Before it, even though the debt to GDP ratio was growing, annual growth in GDP exceeded the change in debt as a proportion of GDP--simply because the debt ratio was a lot lower than it is now. But from mid-1993 on, when the recovery began, the annual growth in debt to GDP outstripped the growth of nominal GDP by an ever-increasing margin. Now, with debt at 153 per cent of GDP and growing at over 14 per cent per annum, the annual change in debt dwarfs the growth in GDP. We have become debt junkies.

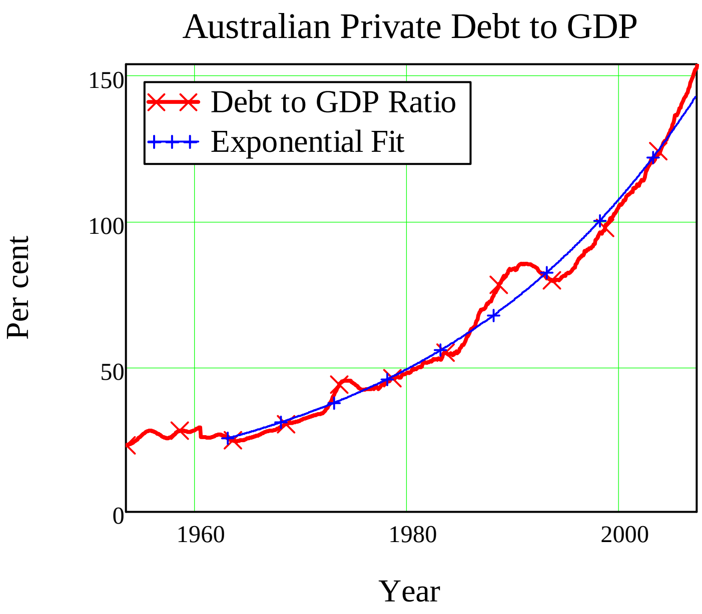


Regular Charts

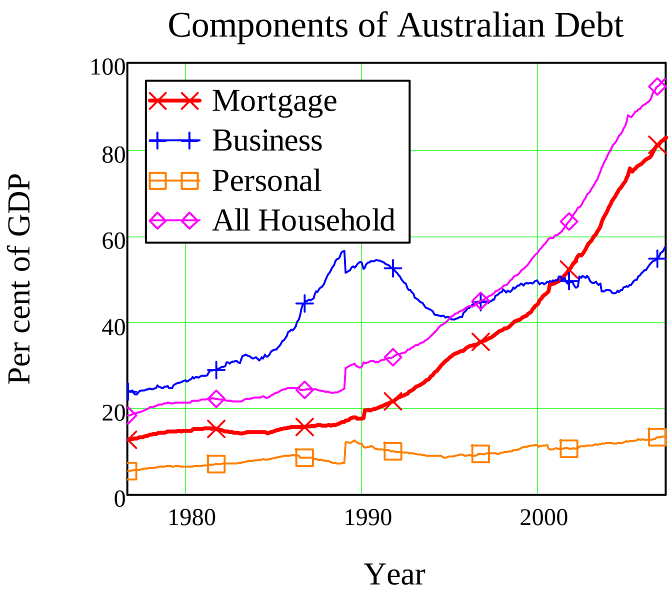
From this month on, I will publish a regular set of charts and tables on my blog at **www.debtdeflation.com/blogs**:look for the "Debtwatch Charts Page" link on the menu These charts are reproduced here. They can be freely republished, so long as attribution is given to Debtwatch. Cite either the blog name and location, or Steve Keen.

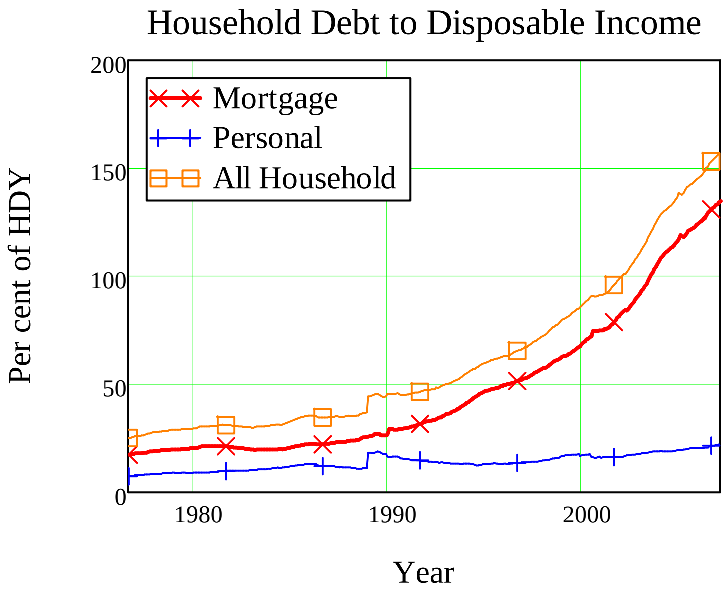
Debt to Income Ratios



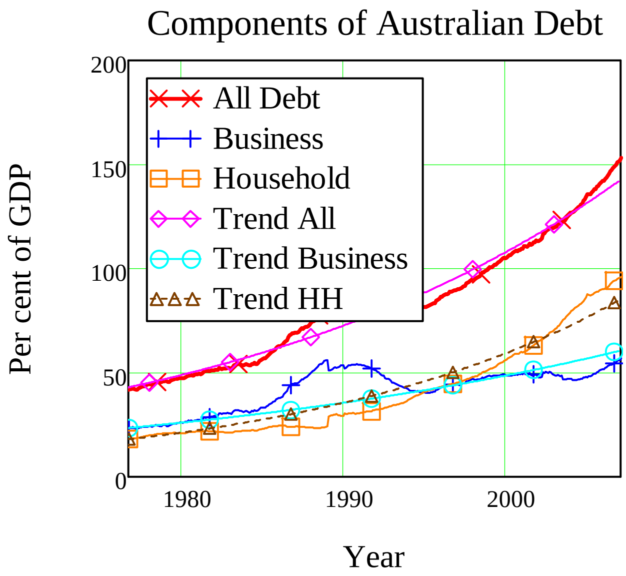


All components of private debt are now at record levels relative to GDP. Business borrowing, which lagged in the aftermath to the 1990s recession, this month reached 57.3 per cent, exceeding the previous peak level of 56.4 per cent in 1988 (a later chart shows however that there is still some way to go before business debt reaches the same proportion of Gross Operating Surplus as in the early 1990s).




Household Debt to Disposable Income
Mortgage
Personal
All Household
Per cent of HDY
200
150
100
50
0
1980
1990
2000
Year


Business Debt to Gross Operating Surplus
Per cent
400
300
200
100
1980
1990
2000
Year



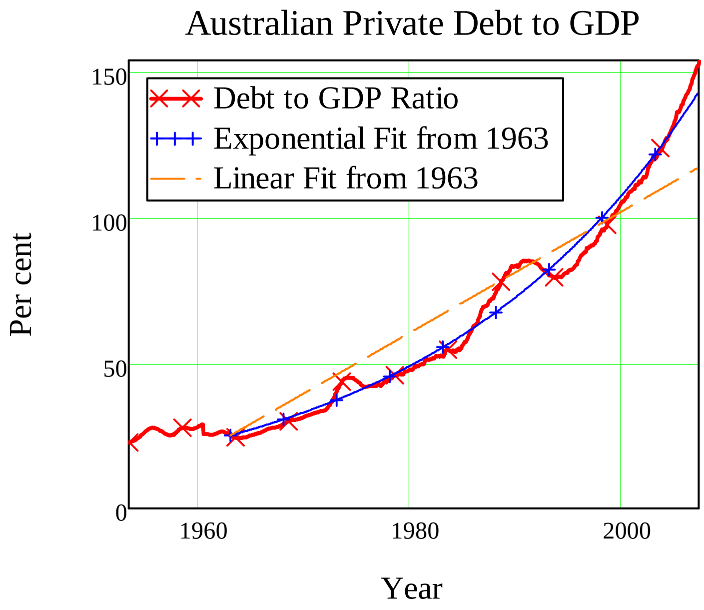
These correlation tables show the annual growth rate of private debt and its various components from a range of starting dates. One important feature of this table is that over the longer term, the exponential growth of debt is more apparent in the aggregate than it is in the components. This indicates that the real source of the problems with private debt come not so much from the borrowing side of the equation, as the lending: in the increasingly deregulated financial system we now inhabit, lenders are clearly motivated to lend as much as possible, regardless of to whom. If businesses cease being a willing repository of debt--as clearly happened in 1990--then lending shifts to another sector, households.

Corr77 =

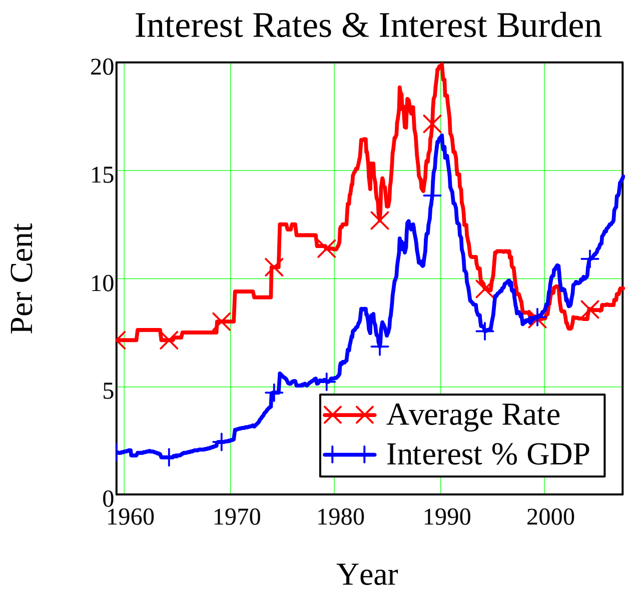
"Debt ratios"	"All"	"All"	"Business"	"Household"	"Mortgage"
"Start Date"	1963	1977	1977	1977	1977
"Growth rate"	3.93	4.05	3.09	5.07	5.75
"Correlation"	99.17	98.42	73.77	98.1	97.95

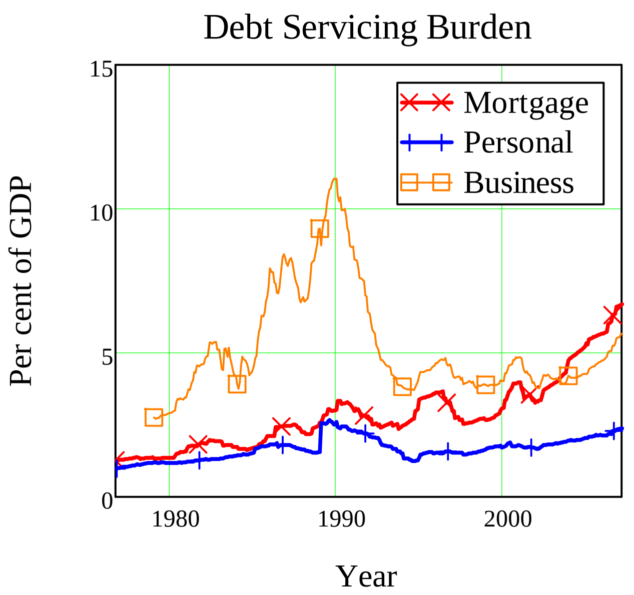
Corr90 =

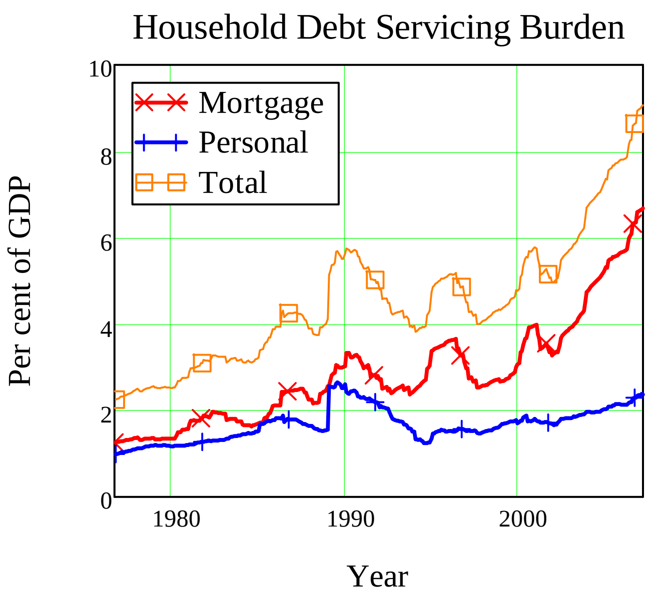
"Debt ratios"	"All"	"Business"	"Household"	"Mortgage"
"Start Date"	1990	1990	1990	1990
"Growth rate"	2.81	–0.95	6.82	9.32
"Correlation"	96.44	–19.03	99.67	99.76

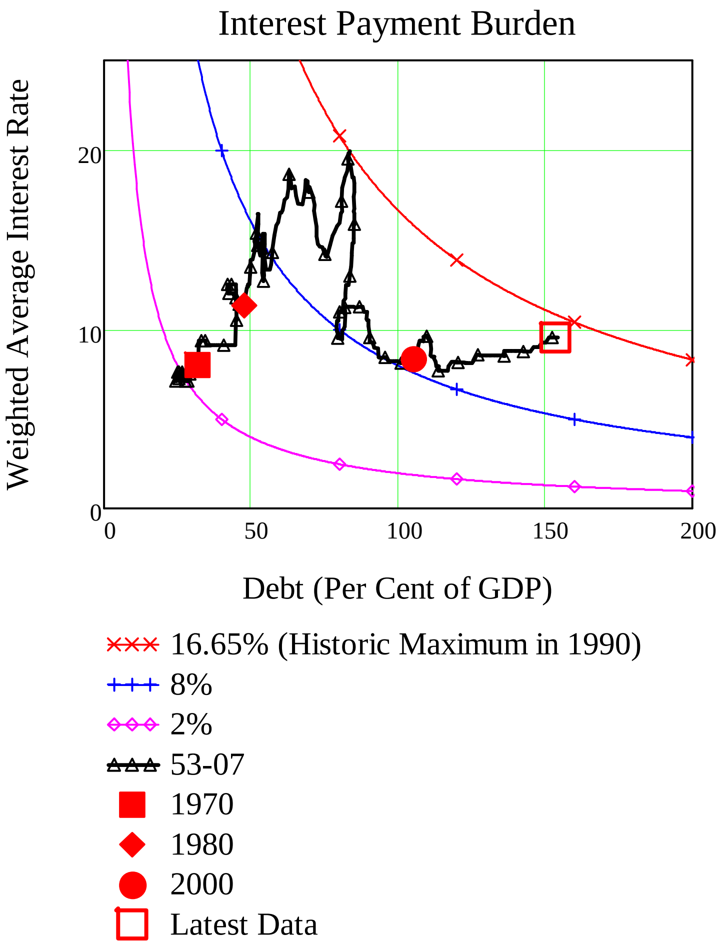


Debt Servicing Burden



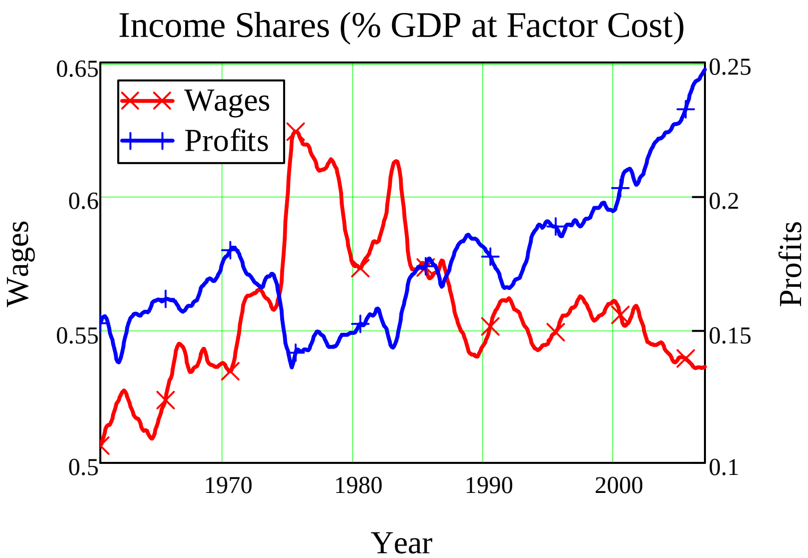

Debt Servicing Burden
Mortgage
Personal
Business
Per cent of GDP
0
5
10
15
1980
1990
2000
Year


Household Debt Servicing Burden
Mortgage
Personal
Total
Per cent of GDP
0
2
4
6
8
10
1980
1990
2000
Year

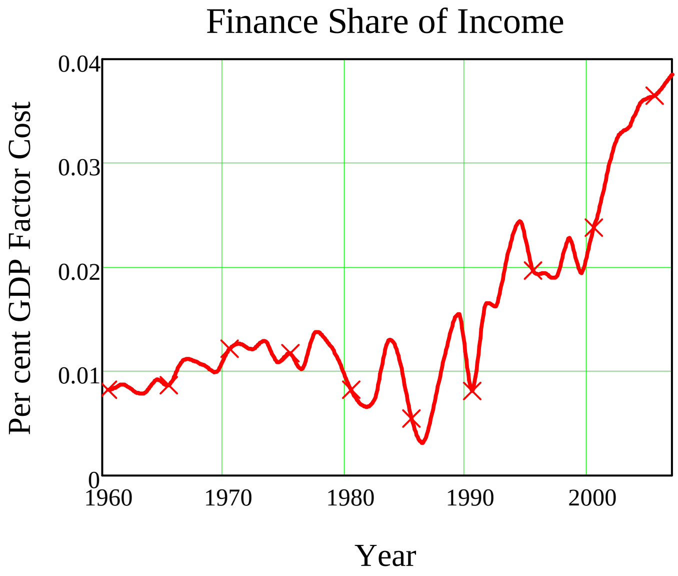


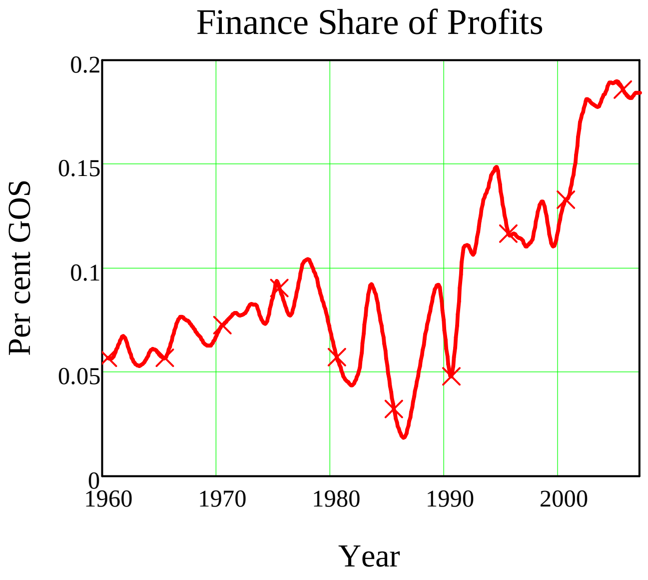
Income Shares

The "real wage overhang" is clearly a thing of the past--if anything, we now have a "profit overhang". The wages explosion of the mid-1970s took the wages share GDP at factor cost to a record 62.4%; since then it's generally been downhill all the way--certainly it has been so since early 1997. On the other hand, the profit share of income is now the highest it has ever been, at almost 25 per cent.

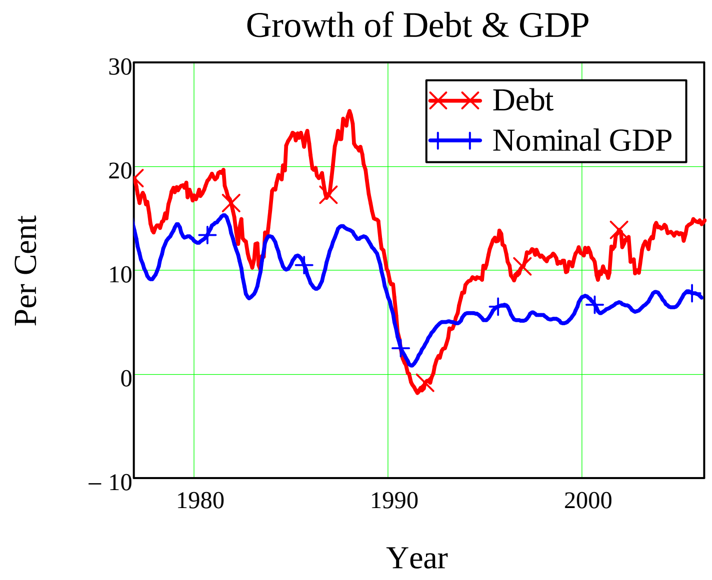


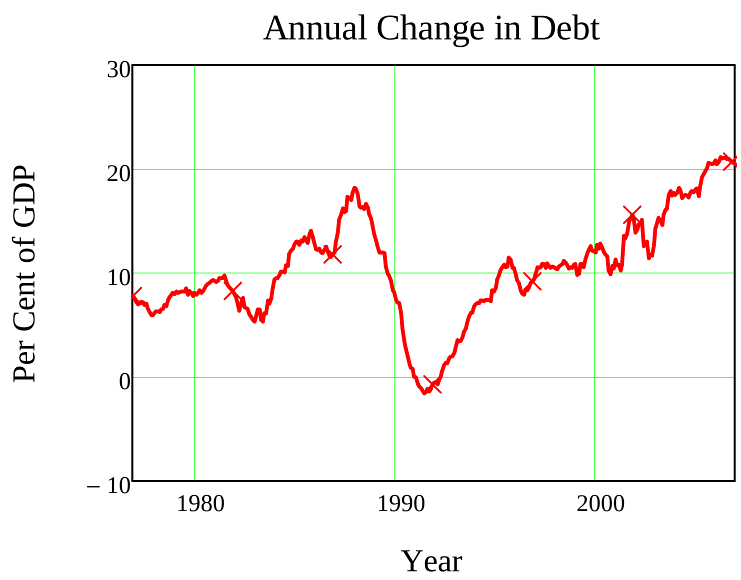
As dramatic as this is, it masks an even more dramatic shift in the increase of the share of profits that is accounted for by financial corporations. Havng been relatively constant at about 1 per cent of GDP, it doubled during the 1990s recession and has since almost doubled again--despite the fall in interest rates since 1990. There are no prizes to any reader of this blog for guessing why this has happened!

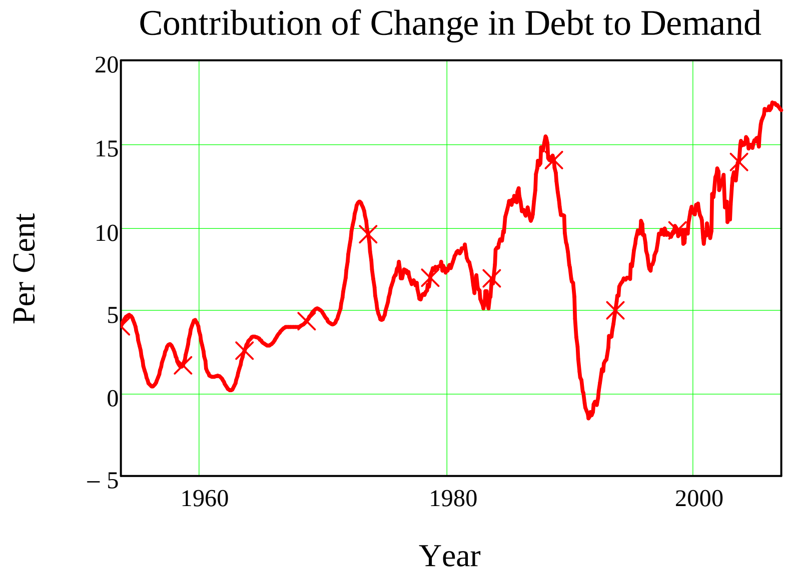


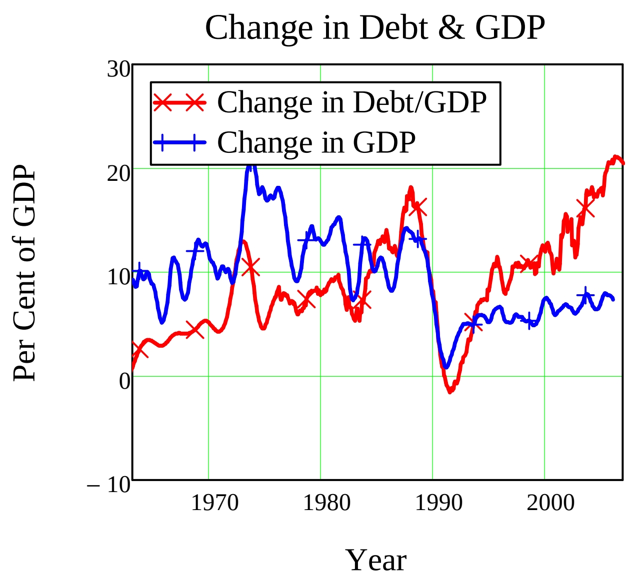


Debt contribution to Effective Demand

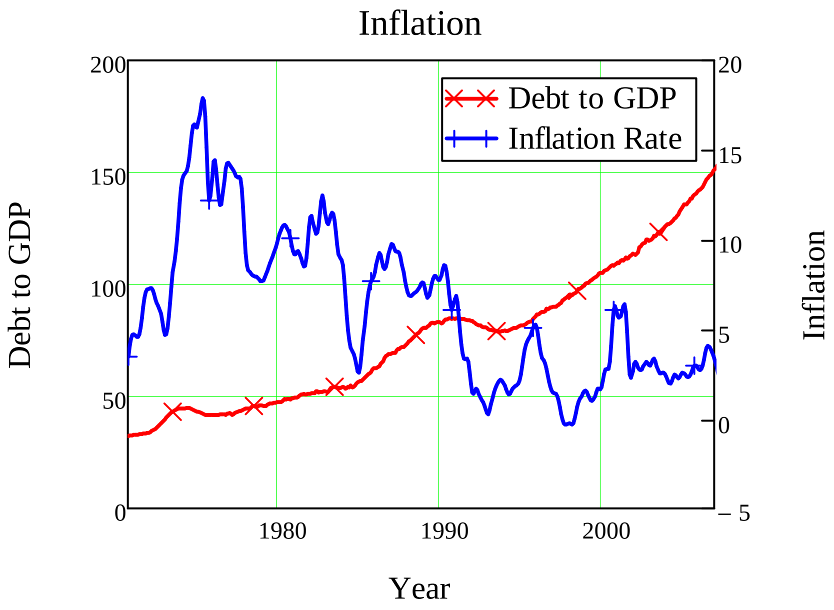




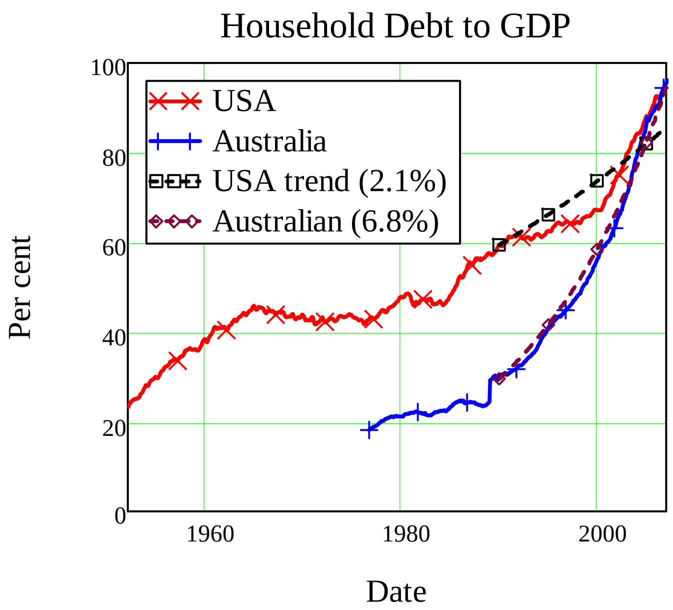


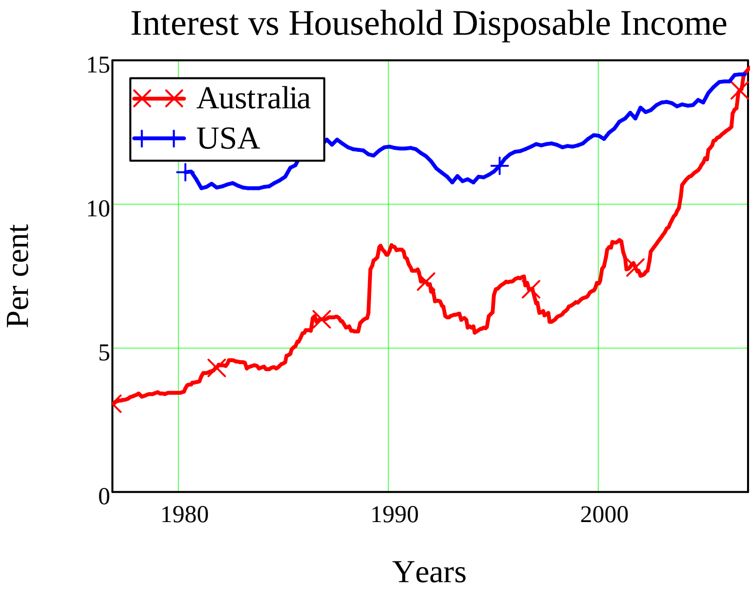


After the last inflation number, the question may soon be "Inflation--what inflation?". This is of coursr a good thing from Pollyanna's point of view--and even Cassandra is pleased since it means the RBA will take its finger off the interest rate trigger. But there is a Cassandra perspective on an inflation rate this low: it could easily become deflation, which increases the burden of debt repayment.



Australia's household debt binge continues to outstrip America's: household debt here now exceeds that in the USA (as a proportion of GDP), and the interest repayment burden on households is the same.





The aggregate USA debt ratio is higher than in Australia--at 160.3 per cent. However it has grown more slowly from a higher base, and a larger proportion of it finances business investment--even though, as in Australia, household debt now exceeds business debt.