

Steve Keen's DebtWatch No. 14 October 2007

The Political Debt Cycle

Both parties will make much of their economic management credentials in this election campaign. Many Australians, on the other hand, seem convinced that the economy would do as well regardless of which party were in power.

The average punter has it right: luck, rather than skill, has determined which governments in retrospect came up smelling like roses in the economic management stakes, and which instead smelt like manure.

By far the biggest determinant of political luck is what was happening to private debt while any given government was in power. If debt was rising, then the government looked good; if it was falling, then the government looked bad.

How come? Because there are two ways in which you can finance spending: you can either earn the money, or you can borrow it. Your total spending in any one year is thus the sum of your income plus the *change* in your debt. The crucial issue is how you spend that borrowed money: if it is being consumed or gambled, then you will come to grief; if instead you are investing in a business, or successfully speculating on shares or houses, then you can pay your debt off and end up much wealthier than when you started.

The same spending equation applies at the national level, so that aggregate demand is the sum of GDP plus the change in total debt. But the conditions under which an increase in debt can be for the good are more restrictive for the nation than the individual. The country can gain if the borrowing finances investment, *but not if it finances speculation*.

Investment--building new knowledge, new factories, new houses--increases the country's income-generating capacity. Speculation--gambling on the prices of shares and houses--just changes who owns what within the country; it doesn't add to aggregate income at all. Borrowing for speculation can be good for the individual speculator who sells on a rising market, but ultimately it just drives the country as a whole deeper into debt.

However, in the game of politics, that economic distinction doesn't matter: a speculative dollar spent boosts demand just as much as an investment dollar. If you happen to come to power when a speculative borrowing binge is on, then you can look like a miracle worker, simply by "*Being There*" at the right time. Woe betide you, however, if you take over power just before a binge comes to an end.

This pattern is remarkably obvious in these two graphs: the first plots the actual debt to GDP ratio, the second plots the annual change in the ratio. When the ratio was rising faster than trend, the incumbent government won plaudits for great economic management; when it was falling, the government was "economically incompetent", and normally lost office.

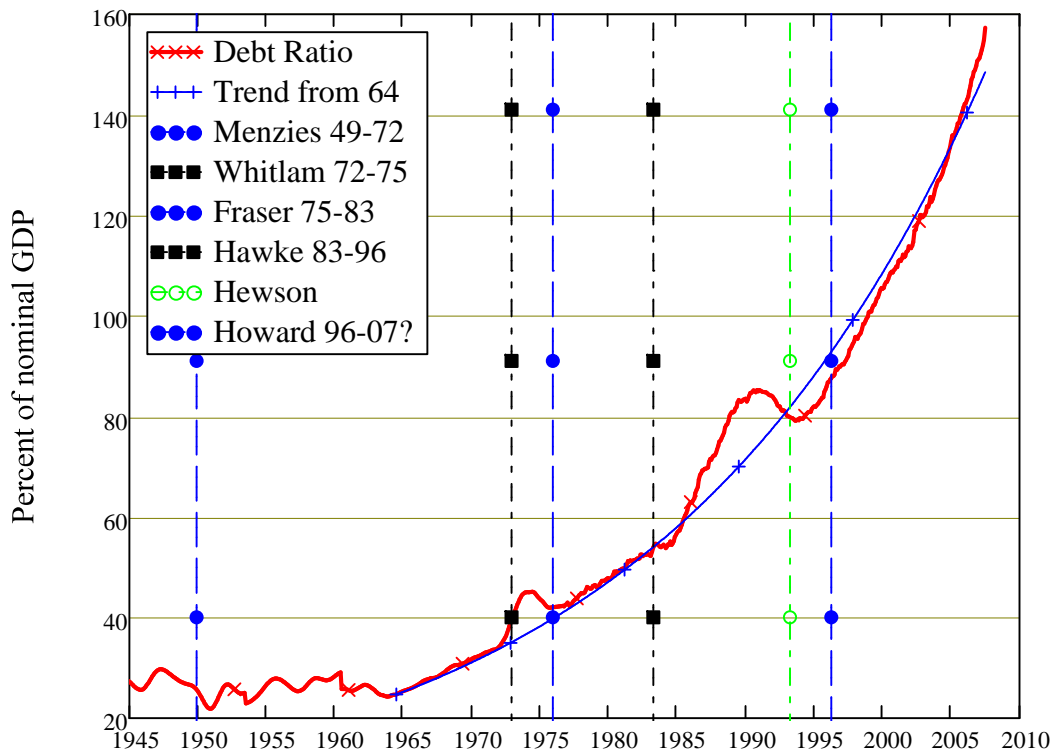
On that front, Whitlam headed the unluckiest government in our history. He came to power after the Liberals had been in power for 23 years, during which time debt was benign for the first sixteen years, and then began to rise in the last eight--making the economy look better than it was. The speculative bubble really took off a year before the 1972 election, and just six months later, it burst (see Chart Two). Aggregate demand took a six percent hit, unemployment exploded from under two to almost six percent (see Chart Four), and Whitlam went down in history as the worst economic manager ever.

Long Term

Chart One

"The market can remain irrational longer than you can remain solvent"

Debt and Politics



Fraser took over when the worst of the plunge in debt was over, and Australia's long-term debt bubble returned to trend. His government won plaudits as responsible if unexciting economic managers, as they muddled through the stagflationary period after 1975.

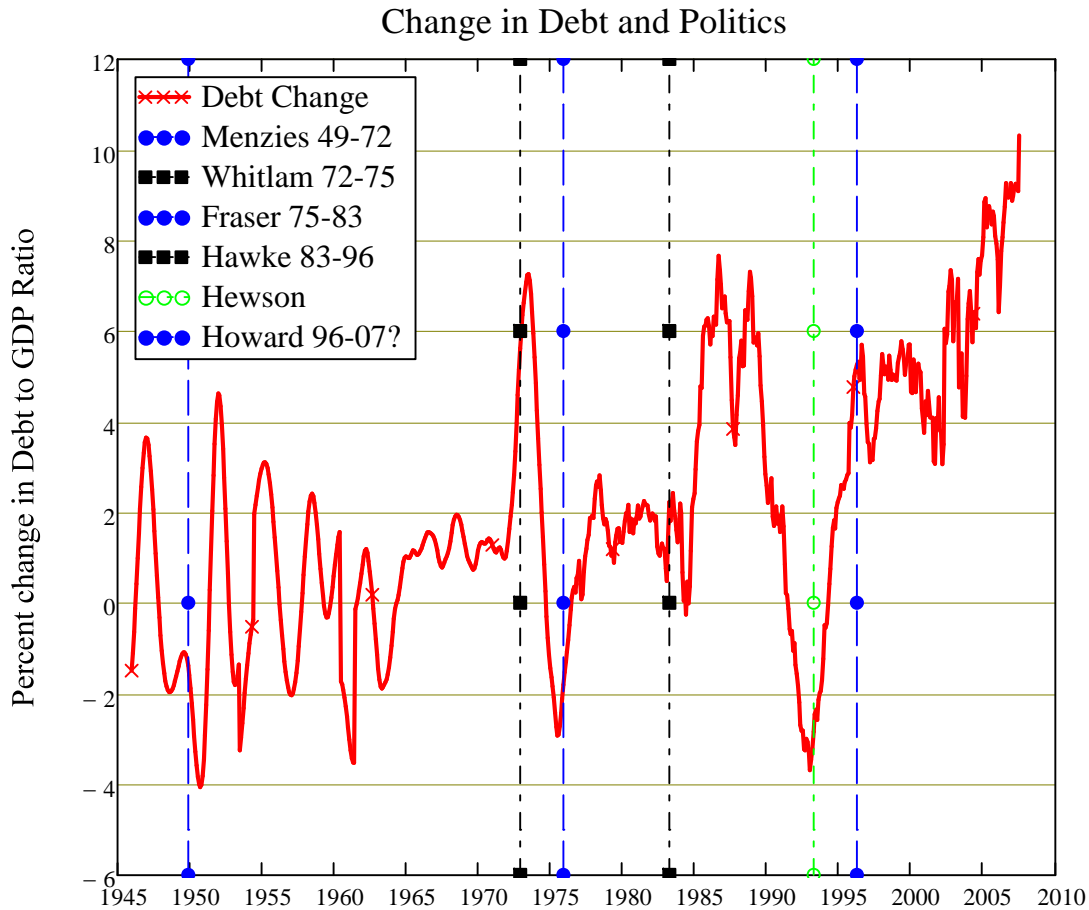
Fraser lost office to Hawke just before the bubble accelerated once more, and the 1980s boom took hold. Hawke proclaimed Keating the "world's greatest treasurer" as the likes of Bond and Skase borrowed their way into economic power and apparent wealth--only for the house of cards to collapse in 1990.

Then, Hewson really did lose the unloseable election: Keating hung on to power even though falling debt was slicing almost 4 percent off aggregate spending.

By the time a more credible leader was in command of the Liberal Party, and the electorate was duly armed with a baseball bat, Keating lost power. Debt was once again bubbling along, and it became the good fortune of John Howard to ride the longest sustained upward trend in debt in our history--letting him take the credit for "good economic management" as private debt reached unprecedented levels.



Chart Two



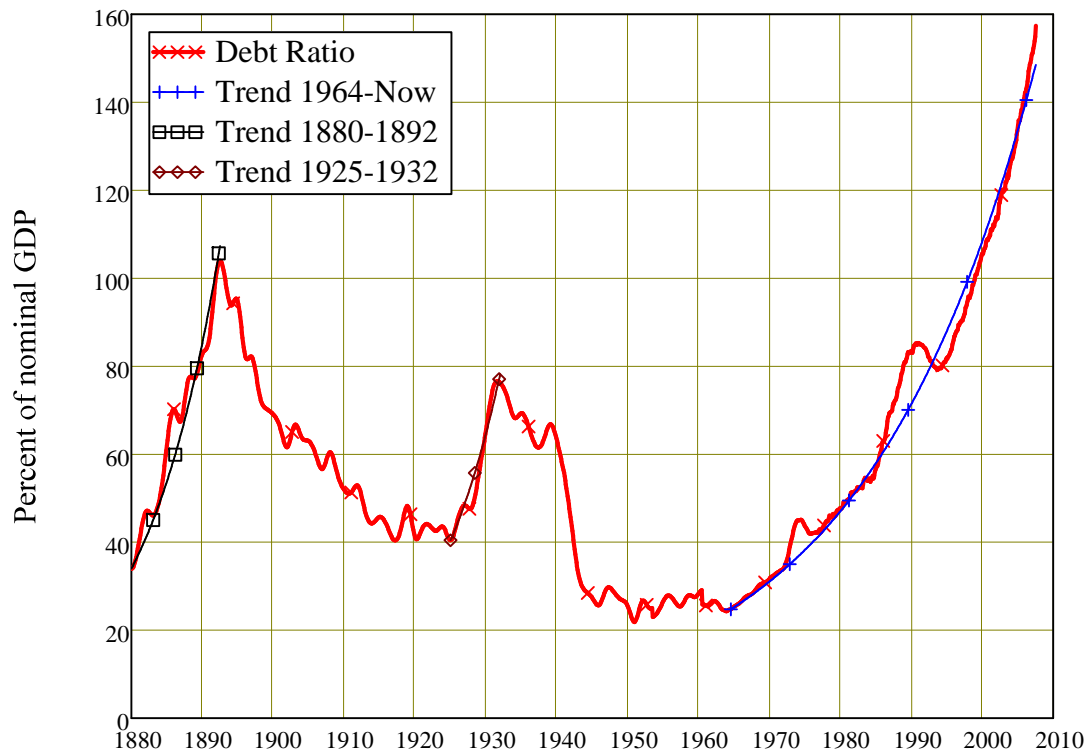
What is likely to happen after the current electoral contest? I don't believe that "business as usual"--borrowing our way to illusory prosperity--is possible any more. We enter the 2007 election with the highest level of private debt in the nation's history--twice what applied during the Great Depression, and one and a half times the previous record, which was set during the Melbourne Land Boom and Bust of the 1880s-90s (see Chart Three).

While it might continue growing for a while, there's no chance that it can continue growing forever. The debt ratio is four times what it was when Whitlam won office, and credit stress is breaking out around the globe as well. Debt will eventually go into reverse, demand will fall sharply--and the incumbent government will be accused of being a "bad economic manager".

In reality, ever since the long term debt bubble began in 1964, the economic management of both parties has been "bad": without being aware of it, they have ridden the coat-tails of speculators into office and out of it again, all the while letting the economy become ever more dependent on debt and speculation.

Chart Three

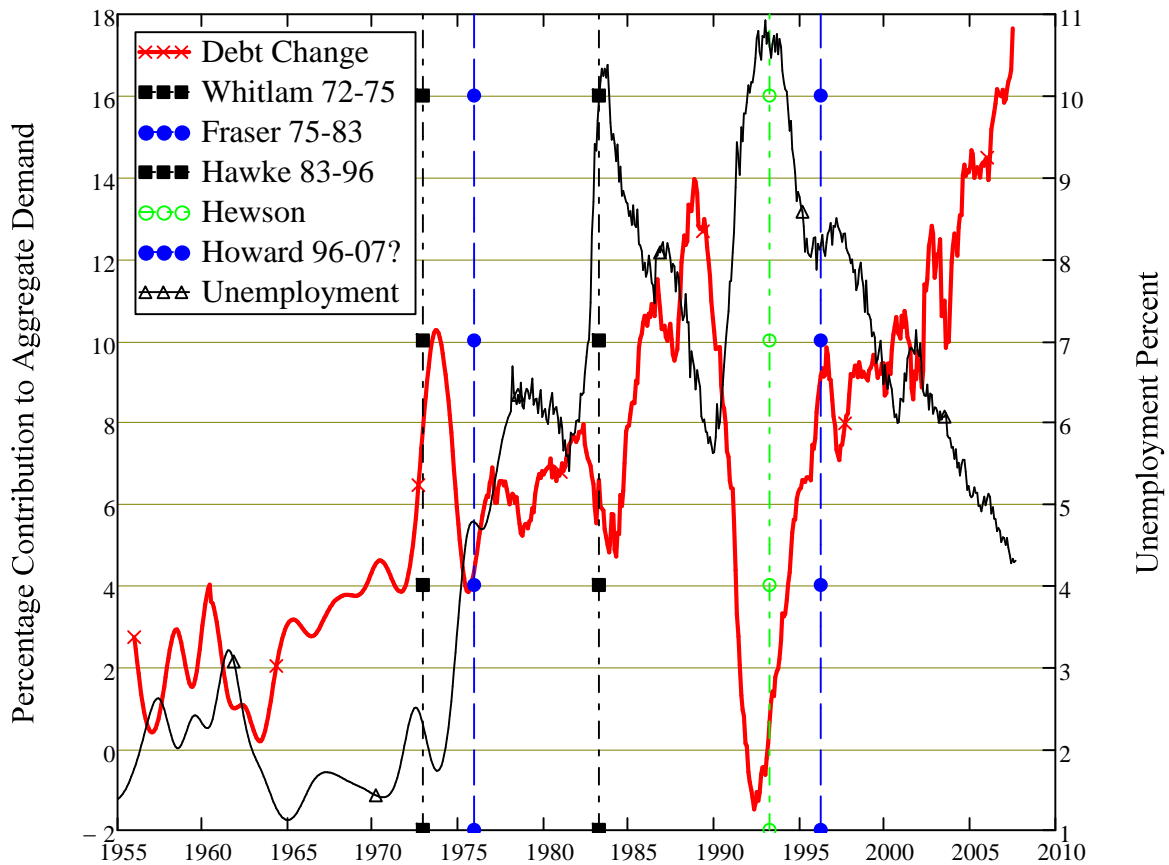
Debt to GDP: The Long Term View



If we fall into a debt-driven downturn after this election, it will not be the fault of the incumbent's policies at the time--whether it is a Rudd Labor or a Costello Liberal government--but the fault of fifty years of allowing speculation to determine both economic policy and economic performance. That is a fault shared across the political spectrum.

Chart Four

Change in Debt, Politics, & Unemployment



Note: the long term graphs in this report were derived from data kindly supplied by the RBA statistics office. The data includes debt to GDP data from Ric Battellino's speech "Some Observations on Financial Trends", and relative market share data from RDP1999-06 "Two Depressions, One Banking Collapse" (I highly recommend the analysis in this report--if you haven't yet read it, please do!).

Aggregate Data and Trend Growth Rates

Debt growth accelerated last month, and the ratio is now a mere smidgin below 160 percent (see Table One). For the second month in a row however, personal debt actually fell (see Table Two). Conversely, mortgage debt rose once more--by quite bit more than the previous month (see the chart on monthly growth rates, below). There is quite a bit of volatility in the breakdown of personal debt, which implies to me that many families are juggling from mortgage debt to credit cards and back again in an attempt to remain solvent.

Debt servicing now accounts for 15.5 cents in the household disposable income dollar--an increase of almost half a cent in the last month.

Table One: Aggregated Debt Summary

Table One

	0	1	2
0	"Summary"	"Total Private Debt"	"Nominal GDP"
1	"Date (levels)"	2007.67	2007.5
2	"Levels (\$m)"	1689604	1045708

D ₁ =	3	"Change Month \$m"	31762	6952.02
	4	"Change Month %"	1.92	0.67
	5	"Change Year \$m"	236319	79033
	6	"Change Year %"	16.26	8.18
	7	"Since 1990"	8.58	5.4
	8	"Since 1980"	11.98	7.93
	9	"Since 1964"	13.48	9.42
	10	"Date (% GDP)"	2007.67	"N/A"
	11	"As % of GDP"	159.48	100
	12	"Change Month"	1.25	"N/A"
	13	"Change Year"	7.39	"N/A"
	14	"Since 1990"	2.91	"N/A"
	15	"Since 1980"	4.1	...

Table Two: Disaggregated Debt Summary

Business borrowing, on the other hand, continues to accelerate, which is no bad thing--at least, not if it mainly indicates rising investment for the China boom, rather than M&A activity. Business debt is now a greater proportion of both GDP and Gross Operating Surplus than it was during the 1990s--see Figures 3 and 7 below. However, business's debt servicing burden is substantially lower than in 1990, since rates are less than half what they were then.

Nonetheless, the combination of still-rising aggregate debt and higher interest rates has pushed the aggregate interest payment burden on the economy to 15.6% of GDP--a level previously only exceeded for one year in Australia's financial history--in 1990 when interest rates were twice what they are now.

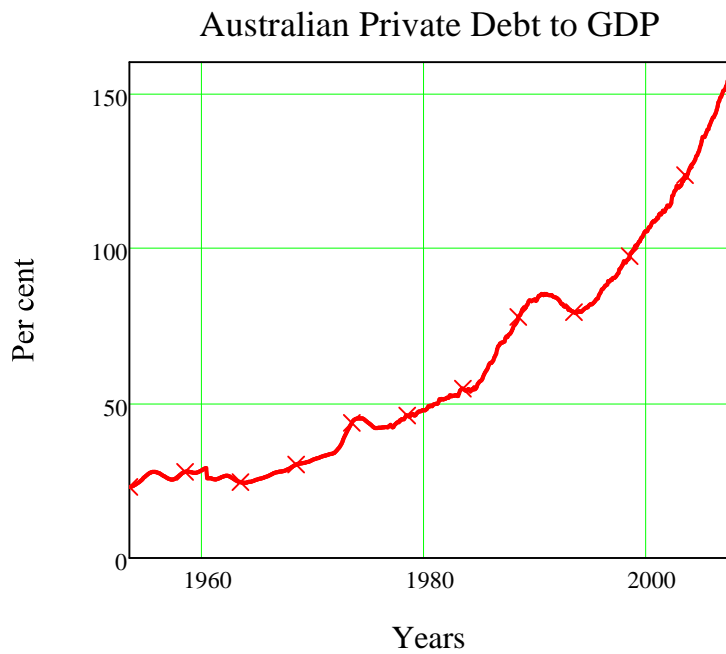
Table Two

	0	1	2	3	
	"Detail"	"Business"	"Mortgage"	"Personal"	
	"Levels (\$m)"	649322	892035	148246	
	"Change Mth \$m"	21285	10530	-53	
	"Change Mth %"	3.39	1.19	-0.04	
	"Change Yr \$m"	119223	98154	18941	
	"Change Yr %"	22.49	12.36	14.65	
D ₂ =	6	"Since 1990"	4.92	14.71	5.45
	7	"Since 1980"	10.61	14.03	10.45
	8	"Since 1976"	11.15	14.3	11.23
	9	"As % of GDP"	61.3	84.21	14
	10	"Change month"	2.73	0.55	-0.67
	11	"Change year"	13.16	3.81	5.92
	12	"Since 1990"	-0.8	9.23	-0.4
	13	"Since 1980"	3.01	6.02	2.62
	14	"Since 1976"	3.07	5.78	2.99

Debt to Income Ratios

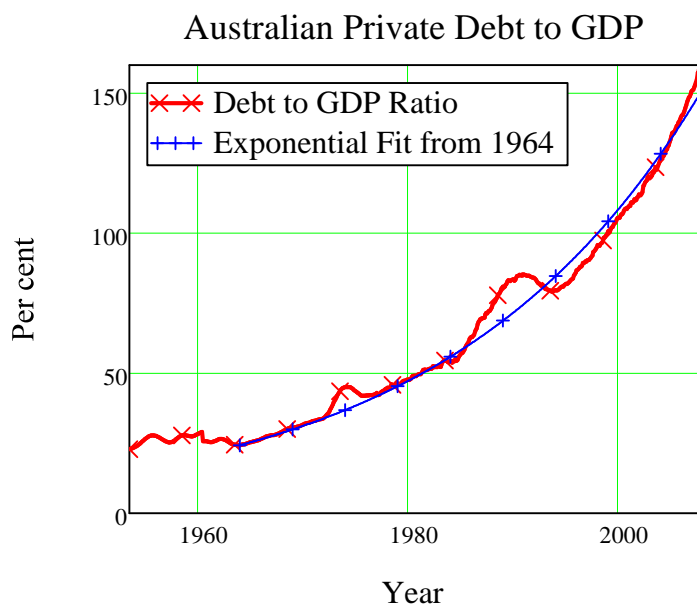
▢ Debt to GDP (D02 & G12)

Figure 1



▢ Debt to GDP Regression

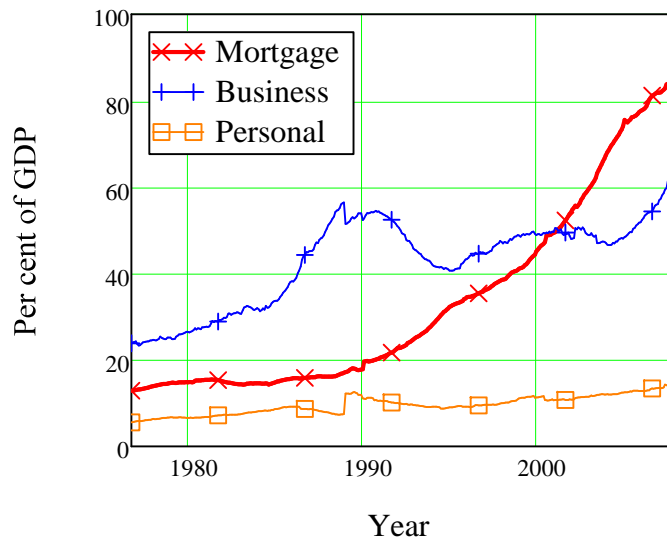
Figure 2



▢ Debt Components to GDP

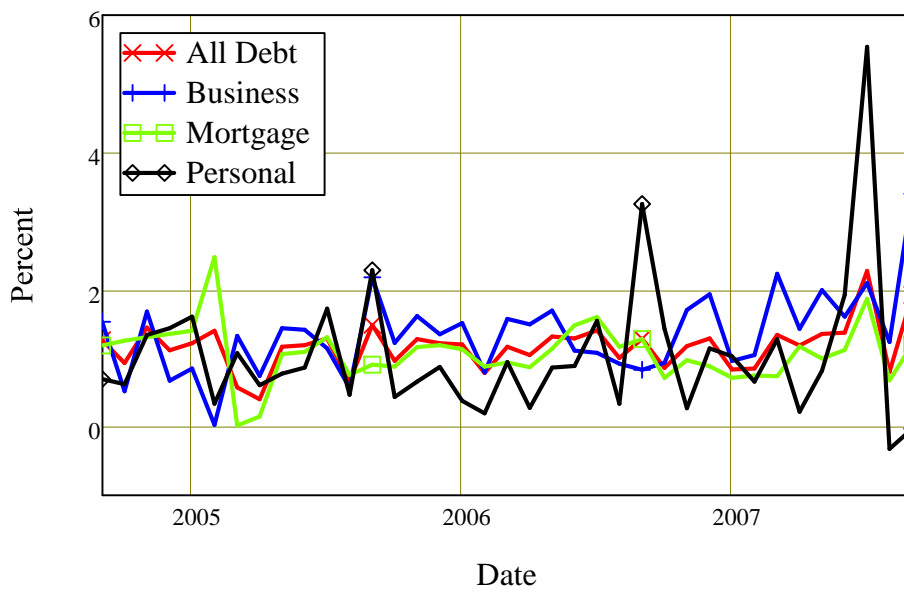
Figure 3

Components of Australian Debt

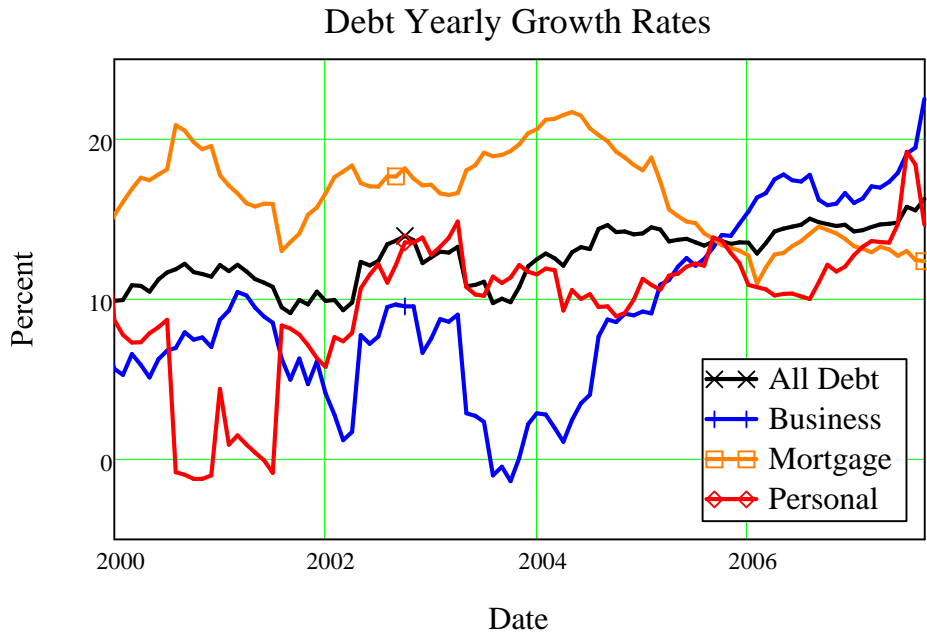


▶ Monthly Growth Rates

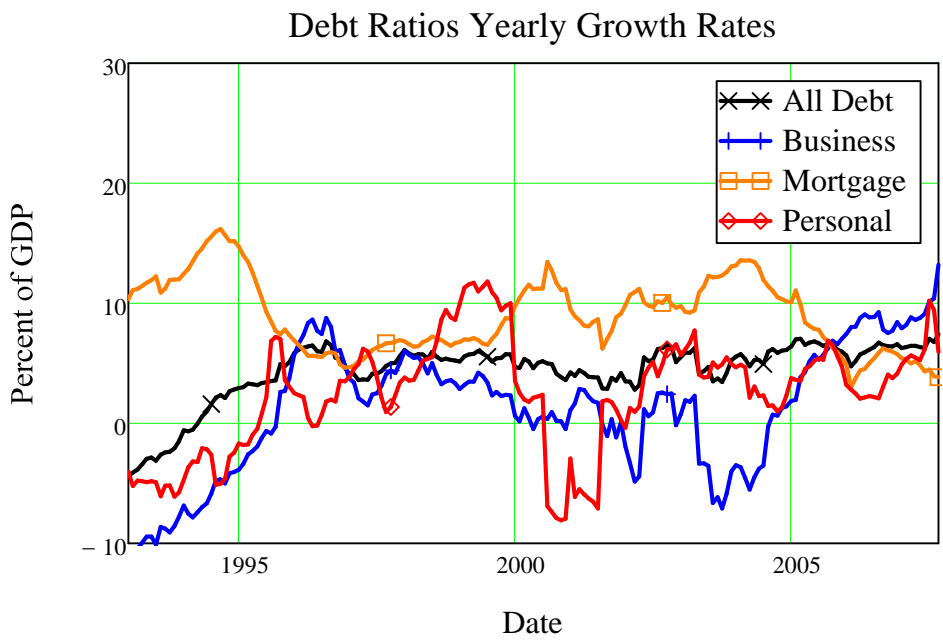
Debt Monthly Growth Rates



▶ Yearly Growth Rates

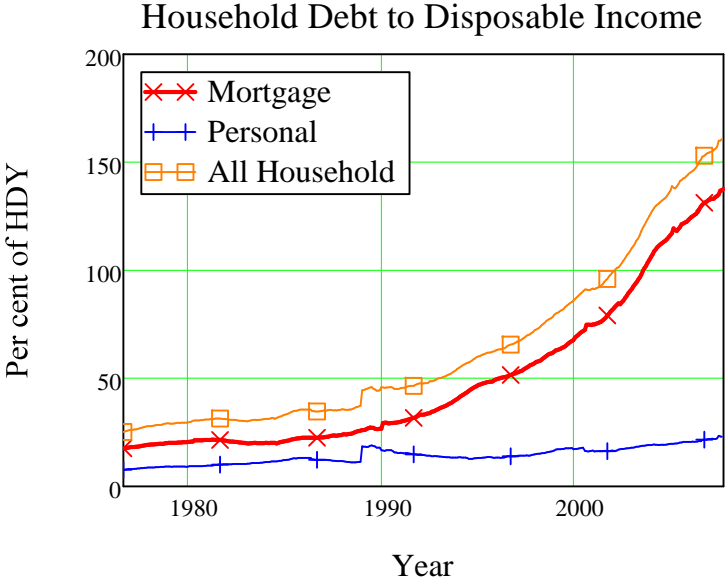


▢ Ratios Yearly Growth Rates



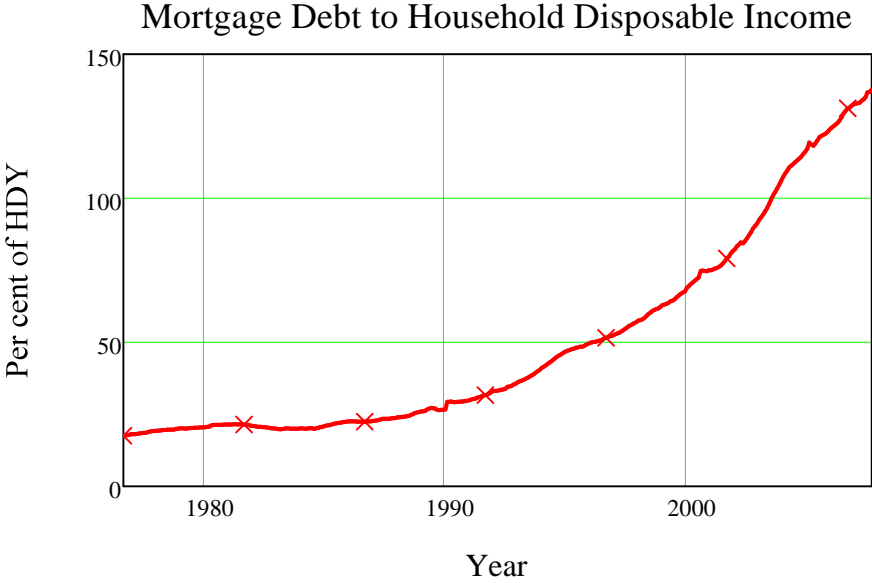
▢ Debt to Household Disposable Income

Figure 4



▢ Mortgage Debt to Household Disposable Income

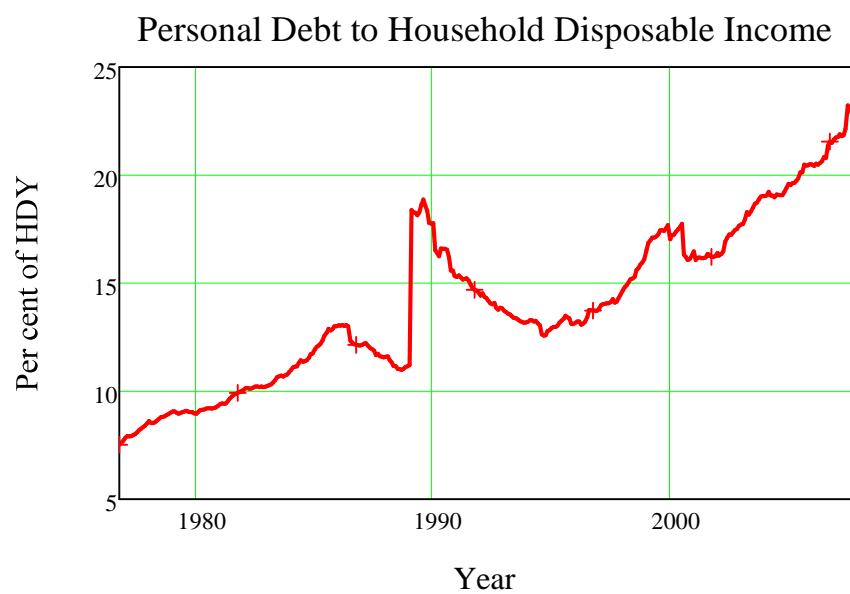
Figure 5



▢ Debt to Household Disposable Income

(the big jump in personal and fall in business debt in 1989 was due to a change in bank classifications of debt types that caused a proportion of business debt to be reclassified as personal).

Figure 6



▣ Business Debt to GOS

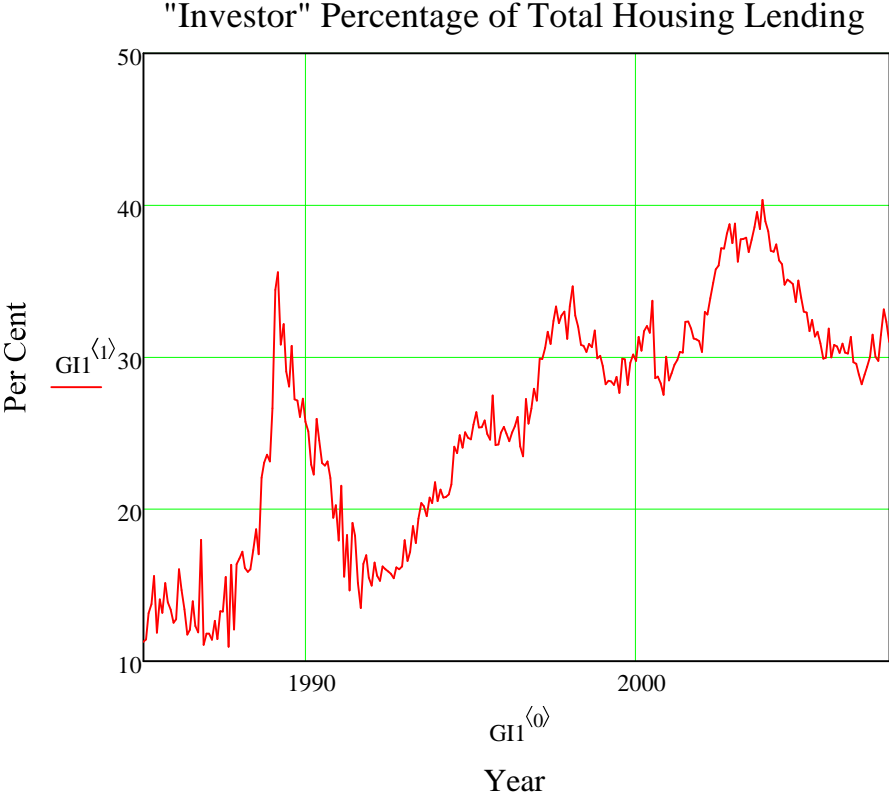
Figure 7



Housing Finance Analysis

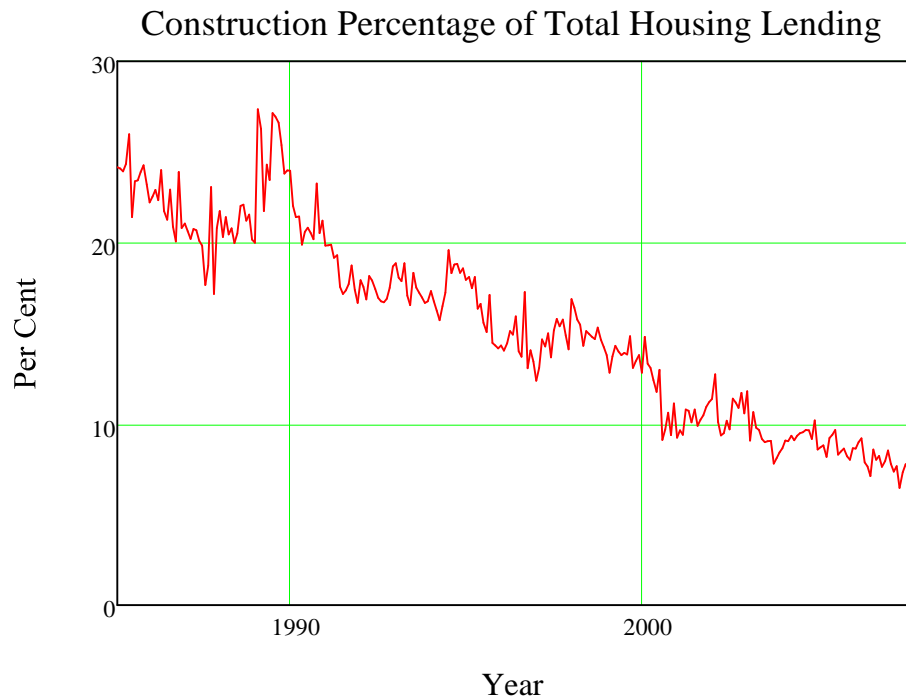
Investment Percent Total Housing Lending

Figure 8



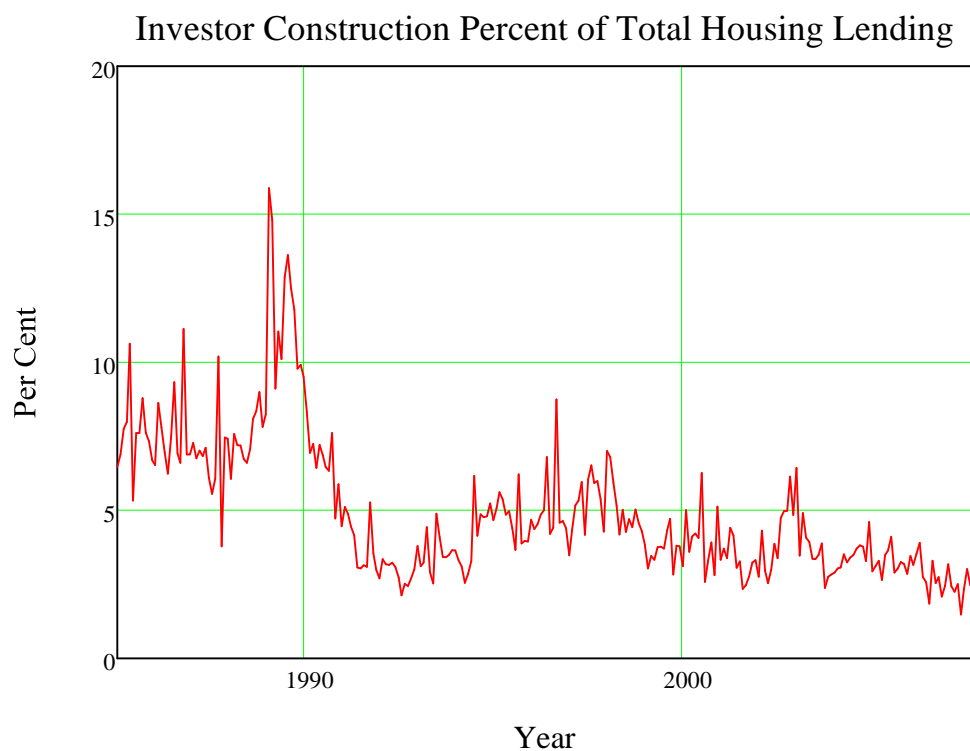
Construction Percent Total Housing Lending

Figure 9



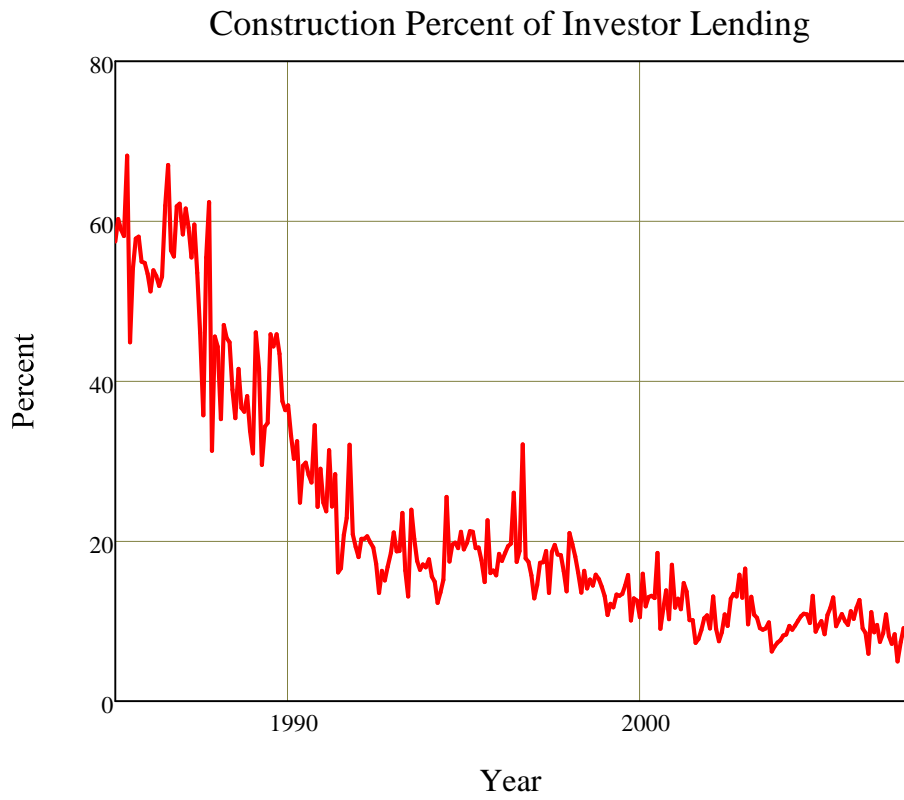
▣ Investment Construction Percent Total Housing Lending

Figure 10



▣ Construction Percent of Investor Lending

Figure 11



Personal Finance Analysis
Figure 12

Credit Card Data

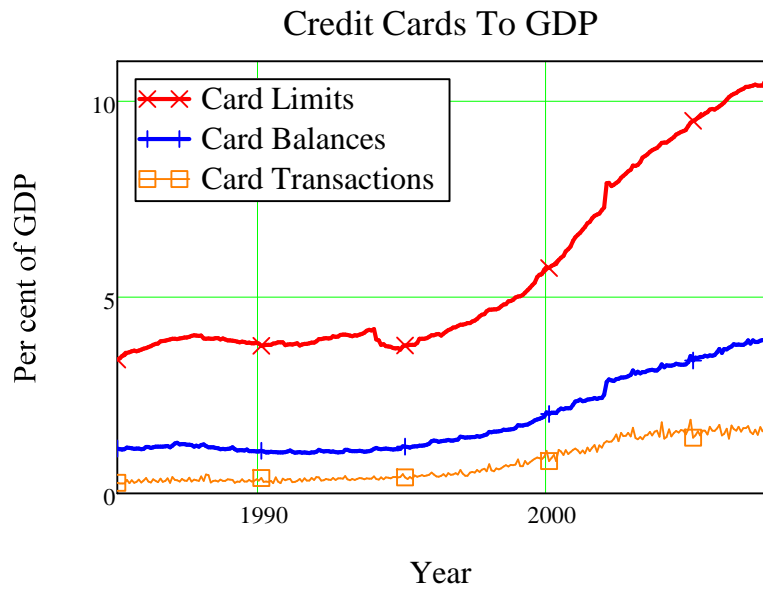


Figure 13

▣ Credit Card Data

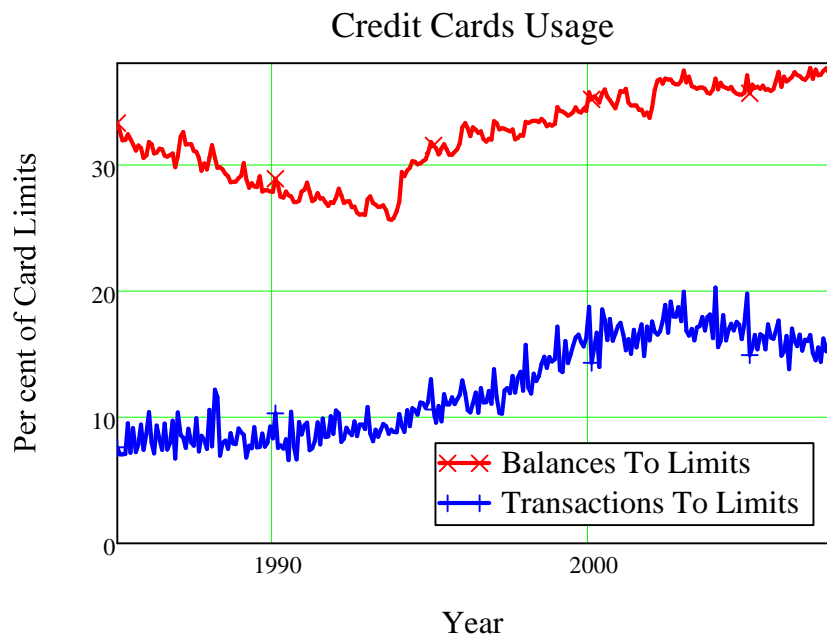
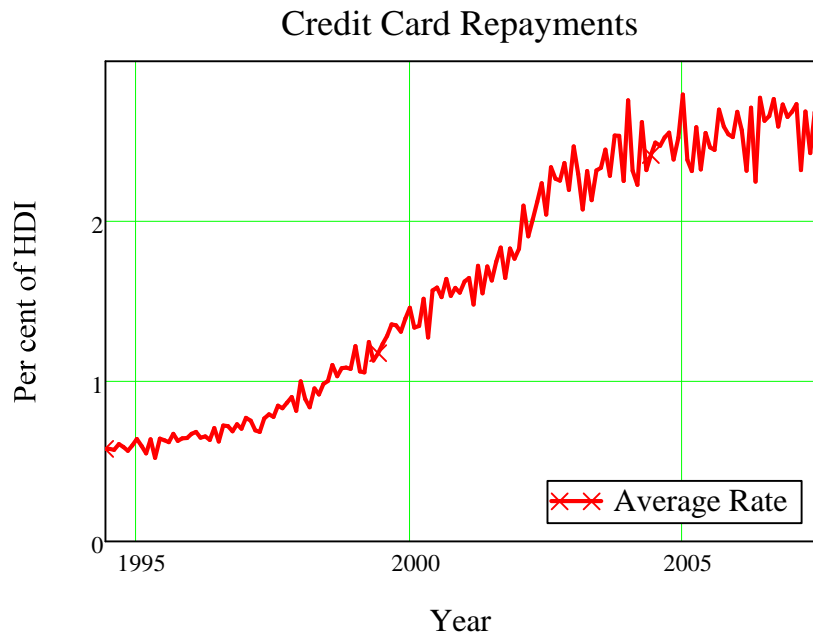


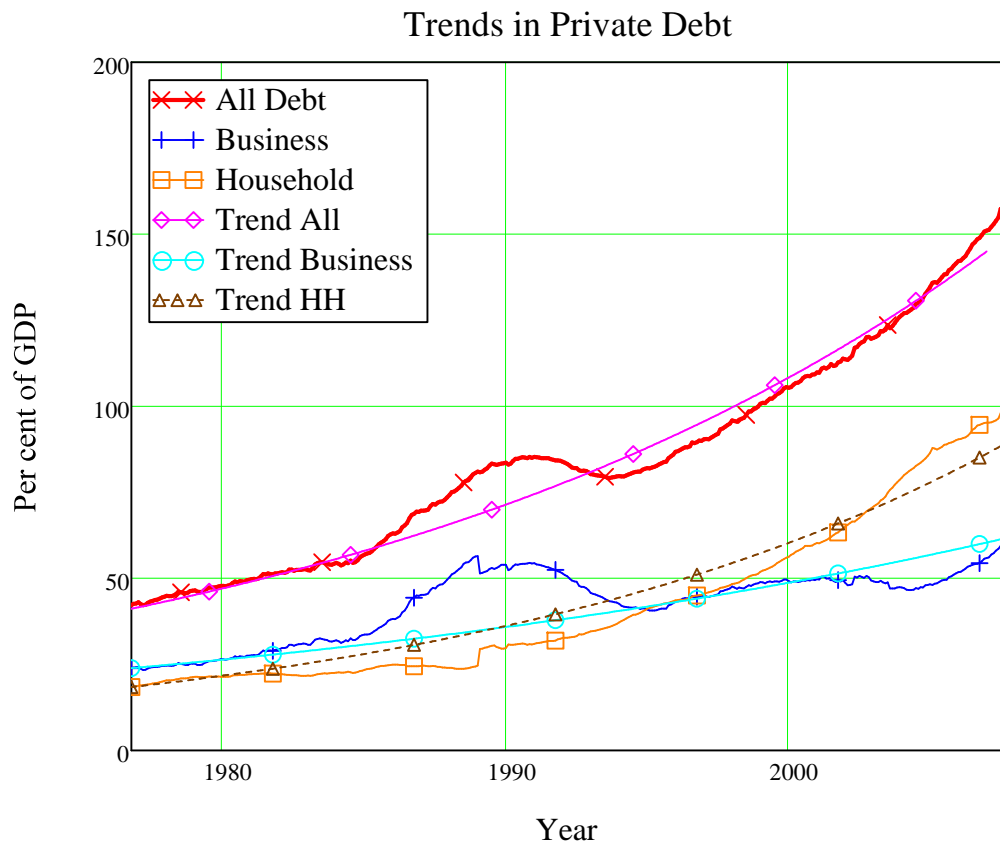
Figure 14

▣ Credit Card Repayments



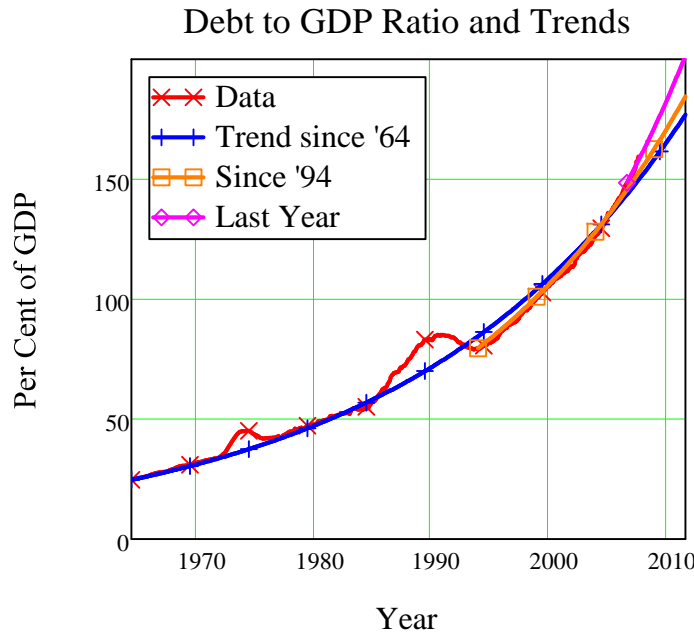
▢ Debt components to Income

Figure 14



▶ Debt to GDP Trends

Figure 15



▶ Debt to GDP Exponential Growth Correlation Ratios

These tables show the approximate exponential rate of growth of debt from various starting dates, and the correlation coefficient between this exponential approximation and the data. The correlation is staggeringly high, especially for a data series which, from an equilibrium point of view, should have no trend, or at worst should move in the opposite direction to changes in the official rate of interest--thus keeping the debt repayment burden constant.

Table Three: Exponential Growth Rates & Correlations since 1964 & 1977

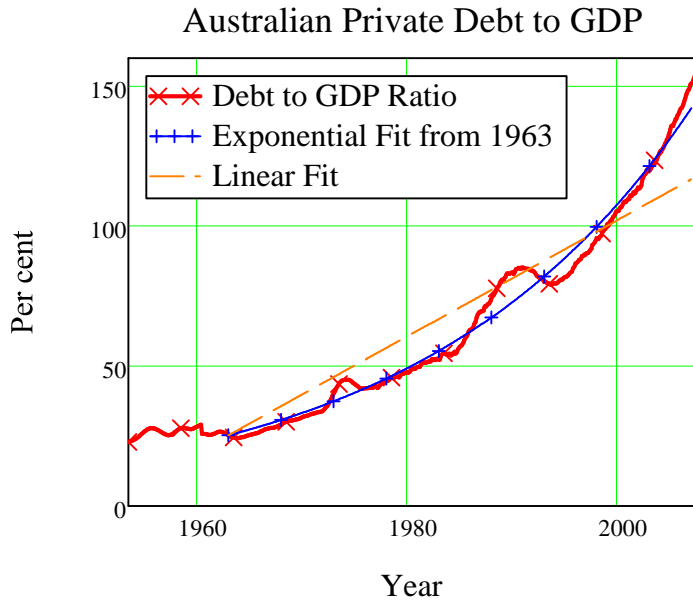
	0	1	2	3	4
Corr77 =	"Debt ratios"	"All"	"All"	"Business"	"Household"
	"Start Date"	"mid-1964"	1977	1977	1977
	"Growth rate"	4.17	4.05	3.09	5.07
	"Correlation"	99.11	98.43	73.45	...

Table Four: Exponential Growth Rates & Correlations since 1990

	0	1	2	3	4
Corr90 =	"Debt ratios"	"All"	"Business"	"Household"	"Mortgage"
	"Start Date"	1990	1990	1990	1990
	"Growth rate"	2.8	-0.97	6.81	9.32
	"Correlation"	96.46	-17.28	99.67	99.76

▢ Debt to GDP Linear vs Exponential Regressions

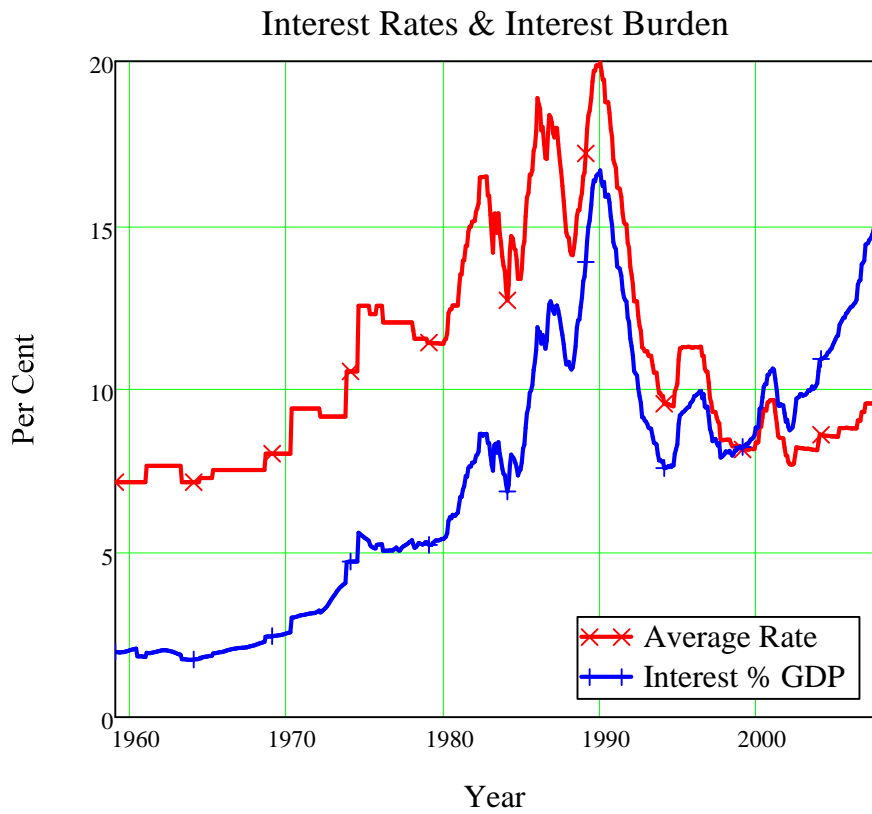
Figure 16



Debt Servicing Burden

▢ Interest Rates & Payments

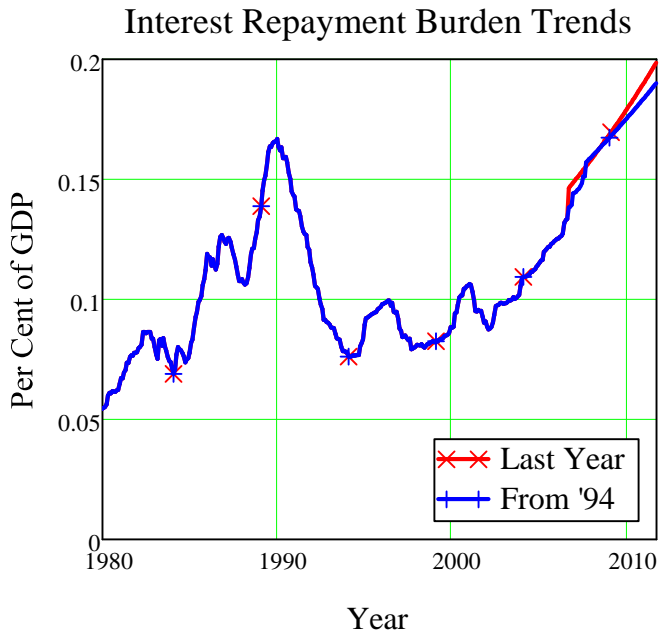
Figure 17



▣ Interest Payment Trends

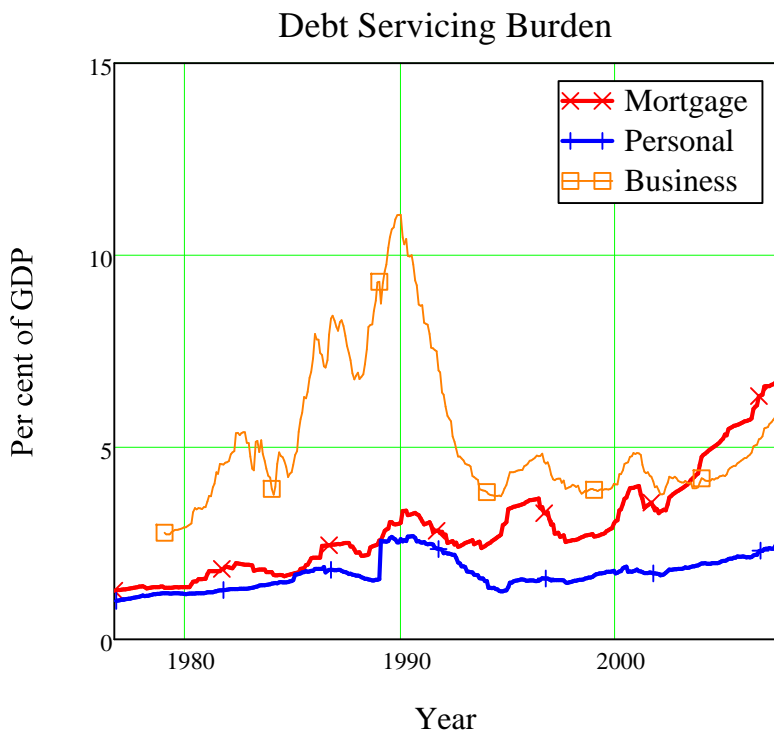
If trends in debt growth continue, then even without any increases in official interest rates, the interest repayment burden on the economy will exceed that of 1990 sometime between September 2008 and September 2009.

Figure 18



▶ Debt Servicing by Loan Type

Figure 19



▶ Household Debt Servicing

Figure 20

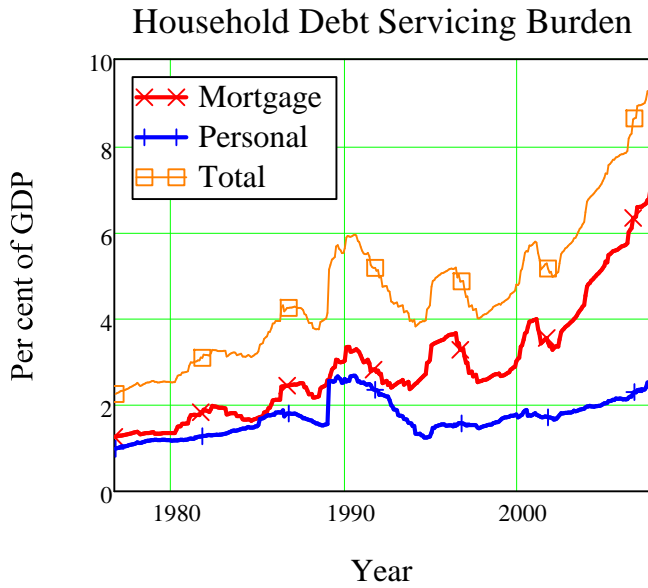
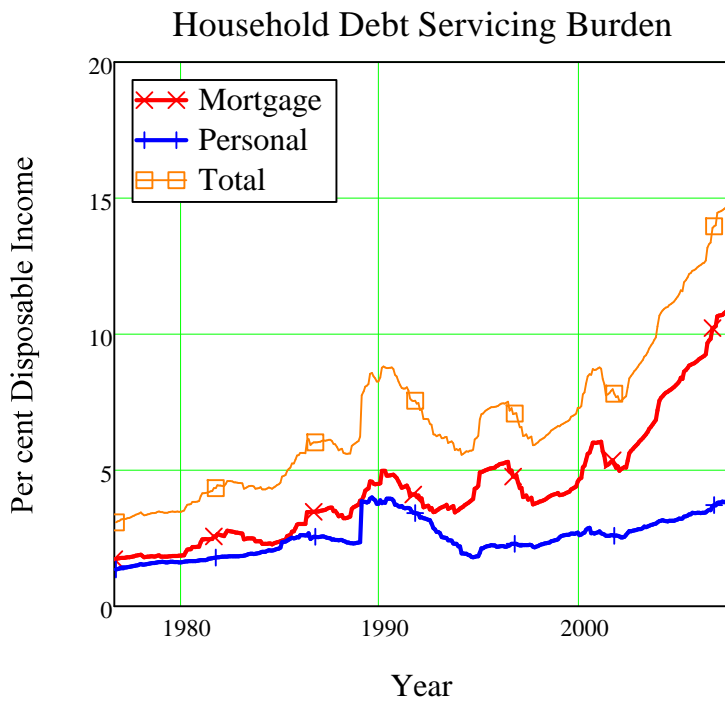


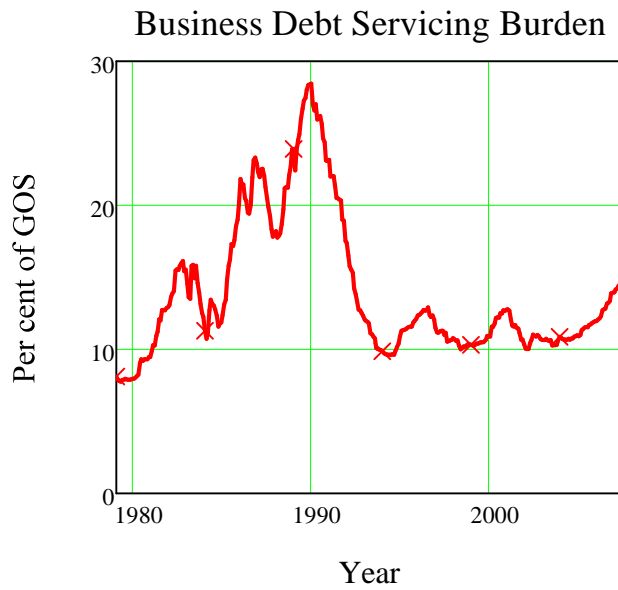
Figure 21



It's obvious why high interest rates prior to 1990 brought the economy to a standstill when one sees the following graph: the interest servicing charge on business loans peaked at almost 30 per cent of Gross Operating Surplus. Even though business debt has recently started to rise as a proportion of GDP, the debt servicing burden remains in the range that applied in the early 1980s.

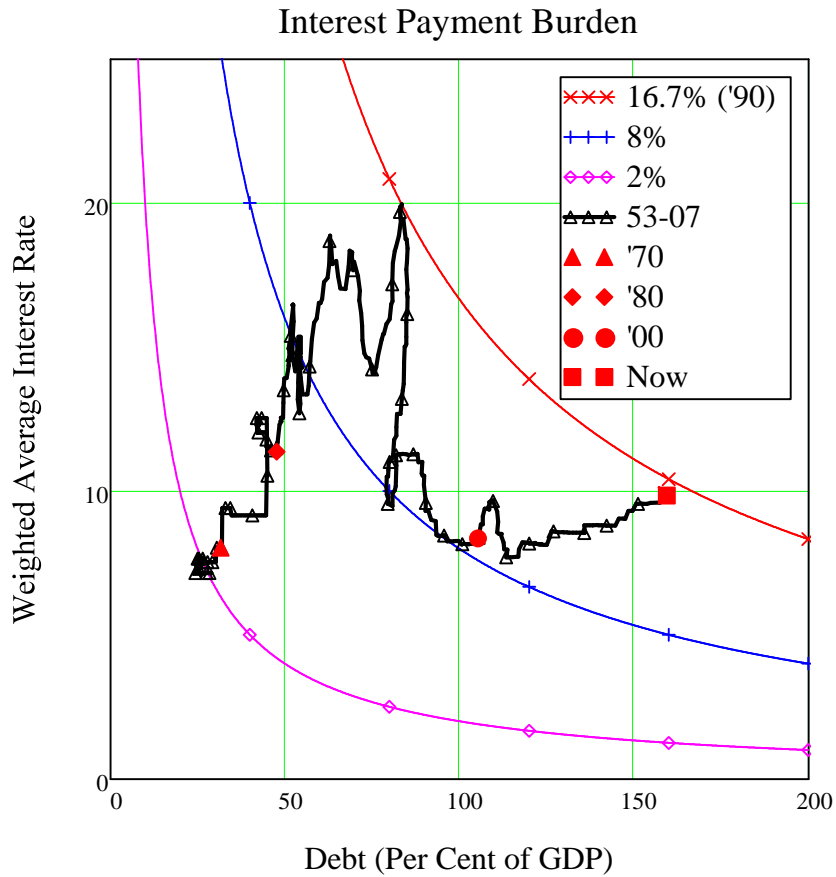
Figure 22





The debt repayment burden is affected by both the rate of interest, and the level of debt. This chart shows the percentage of GDP that is required to pay the interest on outstanding debt, as a function of average interest rates (the vertical axis) and the debt to GDP ratio (horizontal axis). We are approaching the pain threshold that applied back in 1990, when debt servicing consumed 16.7% of GDP. The dramatic rise in household debt in the last thirteen years has almost negated the impact of falling average interest rates.

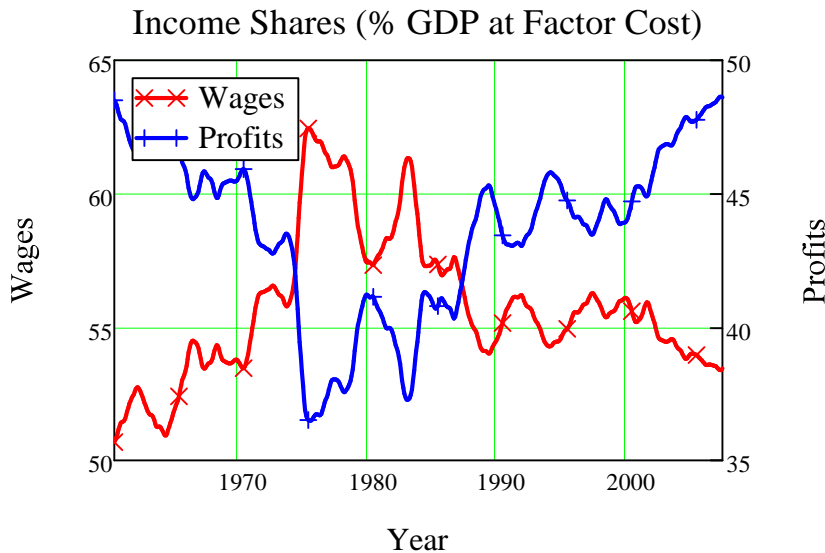
 **Figure 23**



Income Shares



Figure 24



In the "it's an ill wind that blows no good" category falls the impact of rising debt levels on the share of income going to finance capital. Having shown no trend at all between 1960 and 1990, it has suddenly blown out in the last seventeen years, to almost four times the previous average level.

Somehow I doubt that this is a good thing for the rest of the economy. It is instead a very potent indicator of the extent to which financial commitments are a burden upon the productive sectors of the economy.

Figure 25

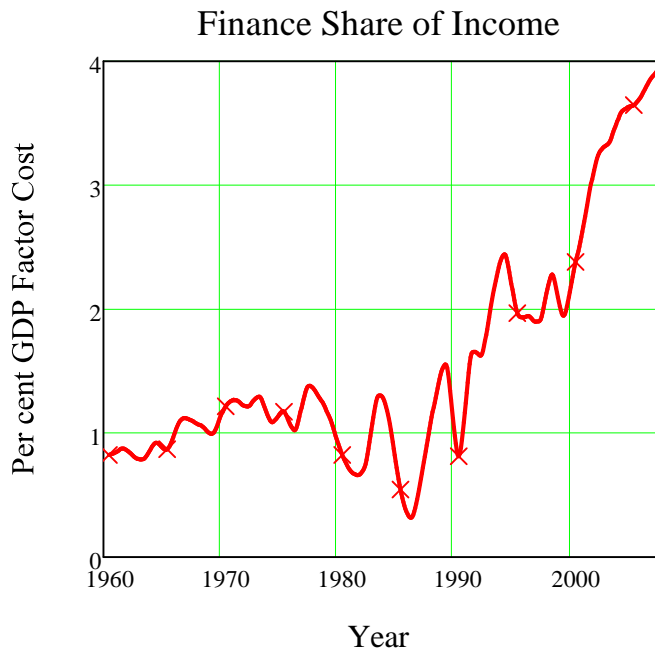
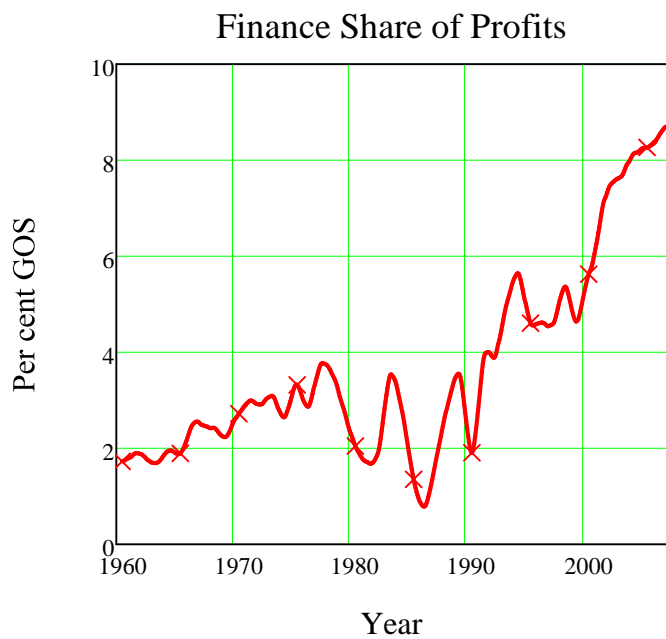


Figure 26



Debt contribution to Effective Demand

Figure 27

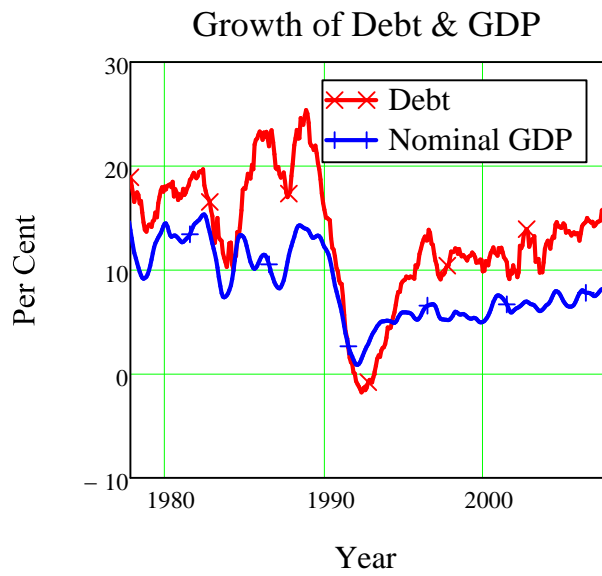


Figure 28

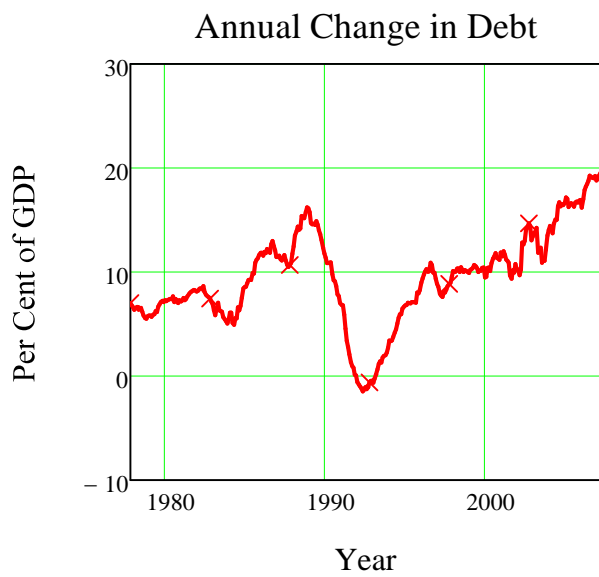


Figure 29

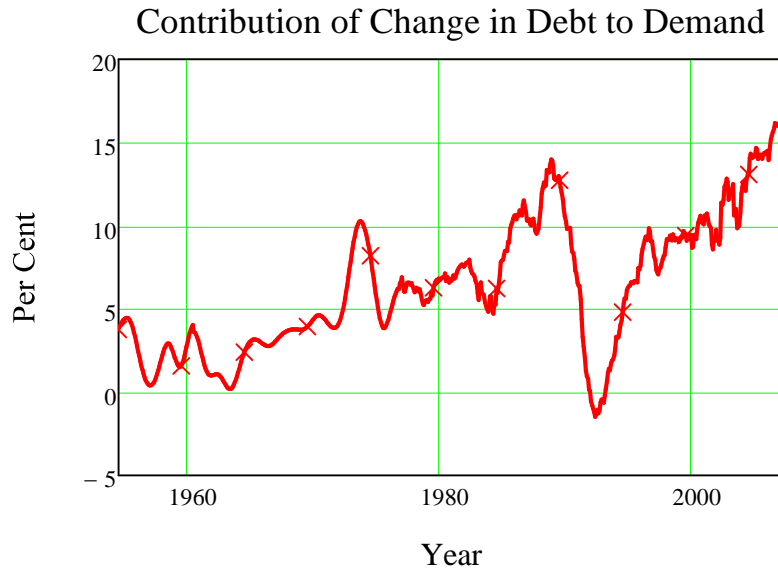
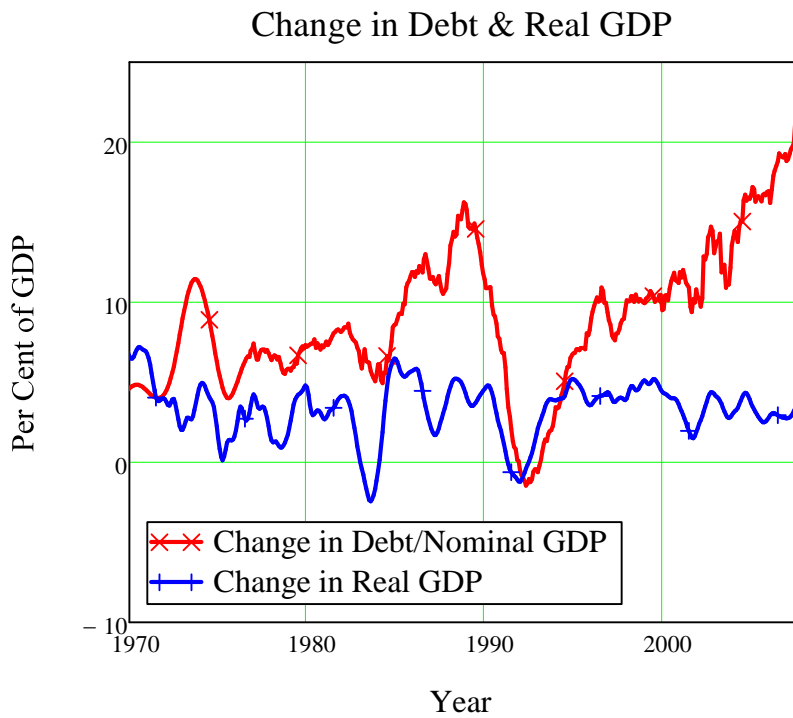


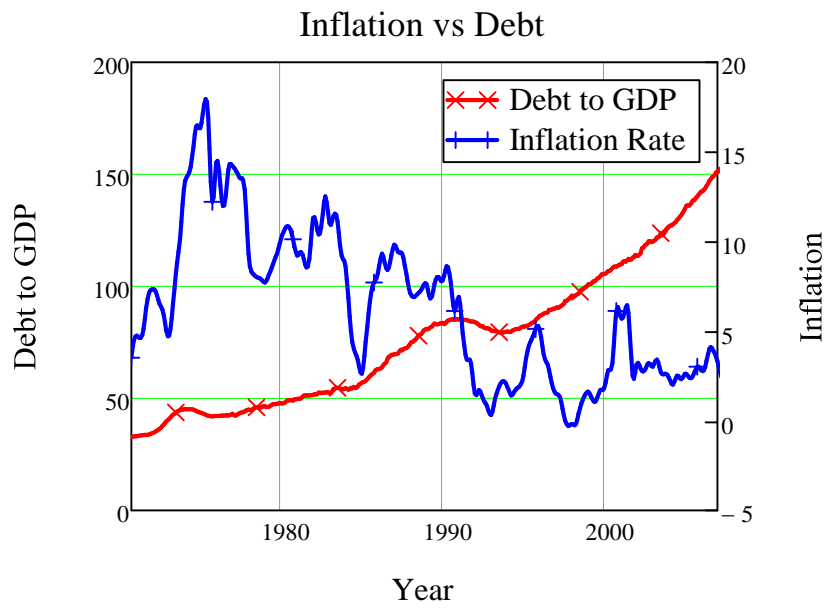
Figure 30



Ignore for a moment the labels on the next graph, and simply imagine that they were indicators on some medical or industrial gauge. Which series would imply an out of control process to you--the red one or the blue one?

Of course, with the bias economists have developed about inflation--and the related blind eye towards debt levels--they ignore the red line, see only the blue line, and worry that this has recently moved up somewhat (even though, over the longer term, it has clearly fallen substantially).

Figure 31



Dwelling Value and Mortgage Indices

Figure 32: Debt trumps prices

