

Steve Keen's DebtWatch No. 15 November 2007

Now is not the time to raise interest rates

Most economists expect the RBA to increase rates at its November meeting, given that its benchmark measures of inflation exceeded its comfort level in the last quarter.

I expect they will too. But I don't believe they should, for three reasons:

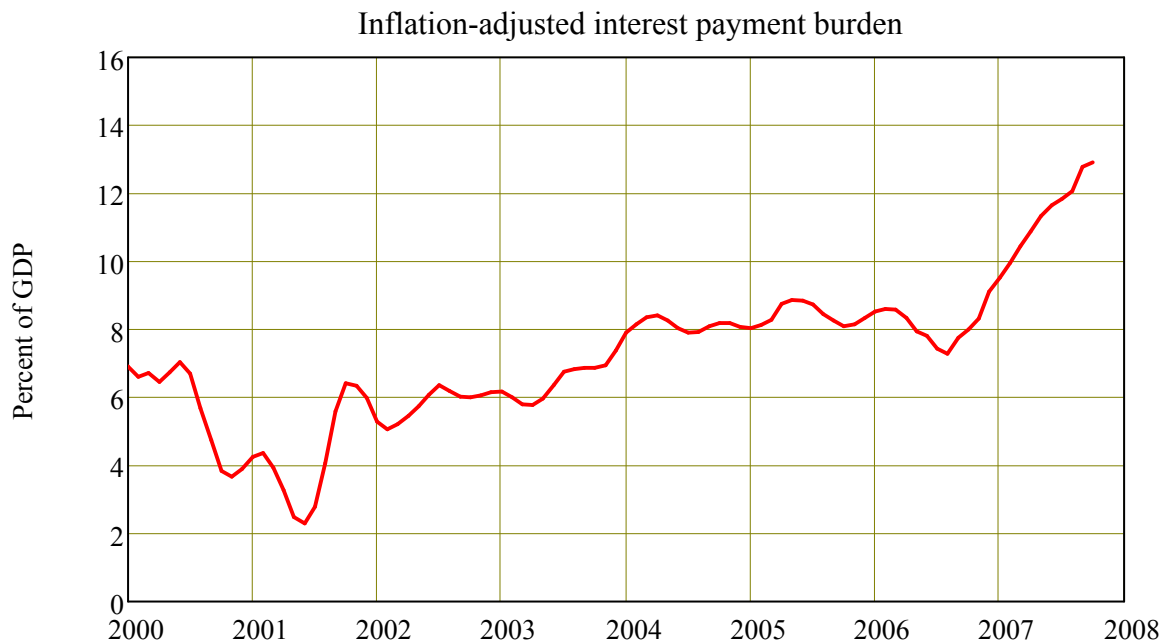
1. Most of the inflation recorded in the last CPI figures was caused by factors that an interest rate rise will exacerbate. Ironically, increasing rates now to control inflation may actually contribute to inflation;
2. Private debt is a far bigger danger to Australia's future economic prosperity than inflation. The interest payment burden today is already higher than it was during the Great Depression. I simply don't believe that the economy can comfortably cope with an even higher burden; and
3. Given our debt levels, deflation is more of a concern than inflation. Australia has had two previous debt bubbles, both of which were followed by Depressions, which were made worse by deflation--falling prices. If history once again rhymes, and today's excessive debt is followed by a serious debt-induced downturn, then the last thing we want is to have deflation occur as well.

Driving inflation lower now may well set up a serious economic problem for the future.

Chart of the Month

At the end of this Debtwatch, I derive the chart below, which shows the interest payments as a percentage of GDP after adjusting for the rate of inflation. This chart could well be the explanation for the mystery that has perplexed the Coalition during this election: why does the electorate seem hell bent on throwing them out of office, even though on all standard indicators, they have "never had it so good".

Chart of the Month: The Real Interest Payment Burden



Long Term

"Talk about centralisation! The credit system, which has its focus in the so-called national banks and the big money-lenders and usurers surrounding them, constitutes enormous centralisation, and gives this class of parasites the fabulous power, not only to periodically despoil industrial capitalists, but also to interfere in actual production in a most dangerous manner--and this gang knows nothing about production and has nothing to do with it." (Marx)

1. The Rental "Catch 22": Interest rates causing Inflation?

Table 1 below lists the rate of inflation for a range of products, sorted from the lowest to the highest rate. There are 4 classifications: Goods, Services, RBA and "FIRE". Goods and services have the obvious meanings; RBA refers to the two special measures that the ABS prepares for the RBA; "FIRE" is an acronym for "Finance, Insurance, and Real Estate" related products.

Table 1

Classification	Group	Annual
Goods	Furniture	-1.3
Goods	Audio-visual & computing	-1.2
Goods	Toiletries	-0.8
Goods	Transportation	-0.7
Goods	Health	-0.5
Goods	Household supplies	-0.4
Goods	Tradeables	-0.3
Goods	Major household appliances	0.1
Goods	Clothing	0.4
Goods	Exc. FIRE	1.1
FIRE	Insurance	1.1
Goods	Market only	1.8
FIRE	Housing	1.8
Group	All groups	1.9
Goods	Footwear	2.2
Group	Exc. Volatile	2.6
Goods	Food	2.9
<i>RBA</i>	<i>Trimmed Mean</i>	2.9
<i>RBA</i>	<i>Weighted Median</i>	3.1
FIRE	Financial and Insurance	3.2
FIRE	Deposit & Loan Facilities	3.4
FIRE	Financial Services	3.5
FIRE	House Purchase	3.5
Services	Non-Tradeables	3.5
Services	Services only	3.5
FIRE	Other Financial	3.9
Services	Utilities	4.1
FIRE	Rents	5.8

Notice that the products whose prices are rising faster than the RBA's measures of inflation prices are overwhelmingly from the FIRE category. Will an interest rate rise reduce the cost of "Deposit & Loan Facilities", or "Financial Services"? Only if it causes demand for them to collapse, I suspect.

But by far the biggest Catch-22 aspect of this data is the impact that higher interest rates will have on Rents.

Rental costs were the fastest rising of all CPI groups over the last year--a 5.8% rise, versus the RBA's imputed average of 3%, the overall average of 1.9% for the year, and the average excluding FIRE of just 1.1%. And now the RBA is planning to **reduce** inflation by **increasing** interest rates...

What influence do you think an increase in interest rates will have on rents?

Rents are rising because we have a shortage of rental accommodation. The shortage exists because we really didn't build many houses during the recent boom--instead, most of the money lent to so-called "investors" was used to buy existing properties, rather than to build new ones (see Figure 1). This speculation drove housing prices to the highest level they have ever been, relative to incomes.

If we want rents to fall, we need to have more rental properties built. But in Australia, rental properties are built by speculators who are really after capital gain--they expect to make a loss on rental income, which they then use to reduce their tax bill via negative gearing.

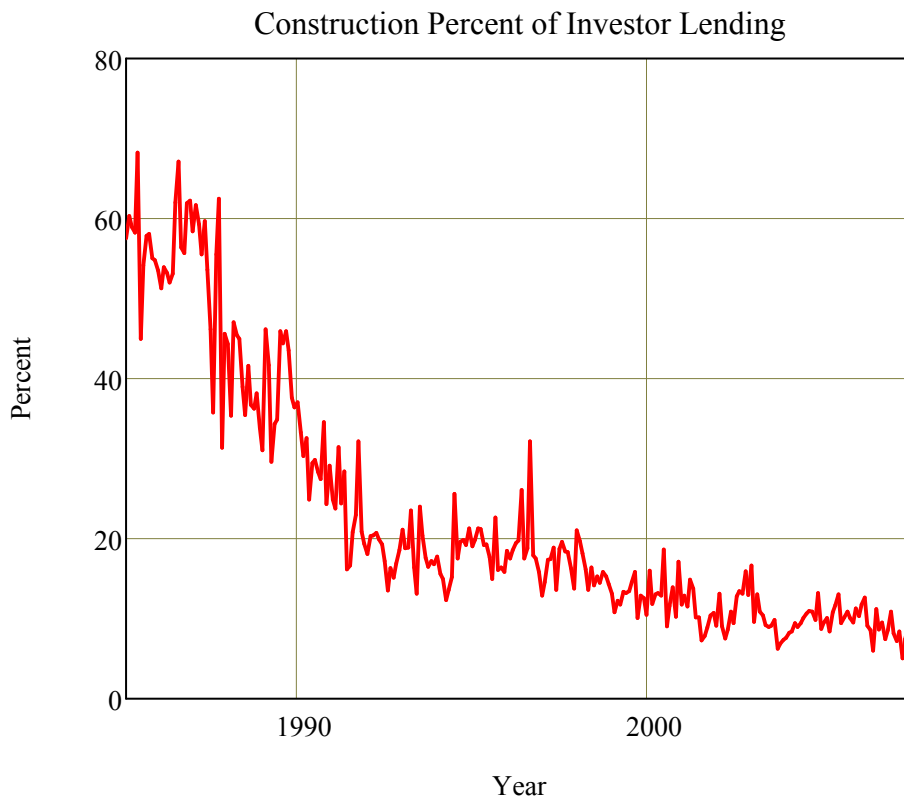
So in our current housing system, if we want to increase the supply of rental properties, we need to encourage house prices to rise even further...

Whatever else increasing rates will do, it is unlikely to encourage the belief that property prices are about to rise. Instead, if rates are increased, there is likely to be even less construction of new rental properties--expectations of future capital gains will diminish, and the development cost of new housing will rise. So the rate rise will act to further dampen the supply of rental properties--which will cause rents to rise further.

And then the RBA will consider increasing rates again to reduce inflation... Even Joseph Heller couldn't script a better farce.

▢ Construction Percent of Investor Lending

Figure 1



2. The biggest debt bubble in our history

Figure 2 (which combines data from Ric Battellino's recent FINSIA address, and market share information from the RBA Research Discussion Paper by Fisher & Kent comparing the two previous bubbles [RDP1999-06]) shows the ratio of debt to GDP in Australia from 1880 till now. It's obvious that there have been three "bubbles" over these 130 years: the Melbourne Land Boom, the Roaring Twenties, and today.

Figure 2

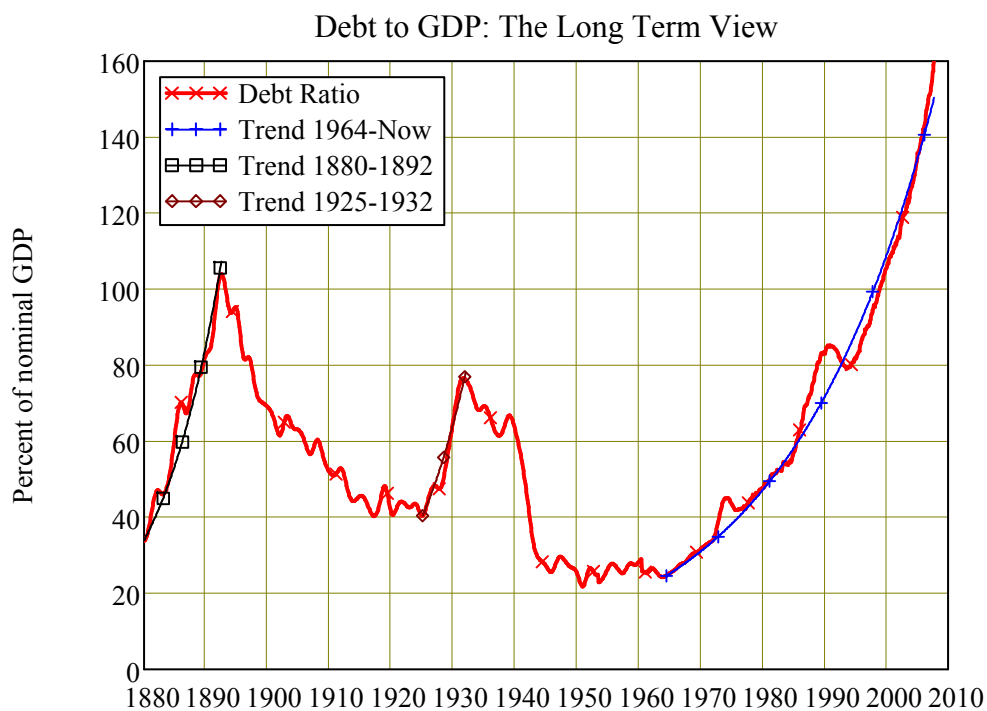


Table 2 numerically compares the three debt bubbles. Though the 1880s and 1920s bubbles were sharper (with annual growth rates for the debt to GDP ratio of over 9%), the one we're living in right now is the longest and largest in our history. Though the ratio has risen more slowly, it has done so for much longer (over 43 years, versus 12.5 and 7 years respectively), and by much more: the ratio is 6.5 times what it was at the bubble's commencement (versus 3.1 and 1.9 times respectively). And it's still rising.

Table 2

Correlation Tables

	0	1	2	3
0	"Variable"	"Credit"	"Credit"	"Credit"
1	"Compared to"	"GDP"	"GDP"	"GDP"
2	"Start Date"	1880	1925	1964.5
3	"End Date"	1892.5	1932	2007.8
4	"Growth Rate"	9.2	9.5	4.2
5	"Correlation %"	97.9	97.6	99.1
6	"Doubling Period"	7.5	7.3	16.6
7	"Duration"	12.5	7	43.3
8	"Initial Value"	33.9	40.3	24.7
9	"Final Value"	103.9	76.2	159.8
10	"Increase %"	206.5	88.8	548.2
11	"Increase ratio"	3.1	1.9	6.5

$G_{01} =$

This, and not a still relatively low level of inflation, is the main danger facing the Australian

economy, and this is what should most concern the RBA. That's not to say that I believe they have the tools to do anything to control it; but they should at least consider the danger of doing anything that might exacerbate it. This leads to my third issue--the interplay between interest rates, inflation, and the debt to GDP ratio.

3. The debt deflation danger

There are three factors that determine how much impact a rate rise has on the economy: the interest rate itself, the inflation rate, and the level of debt. The mathematical models that the RBA uses to guide its decision-making about interest rates and inflation consider the first two factors of course. But they ignore the third.

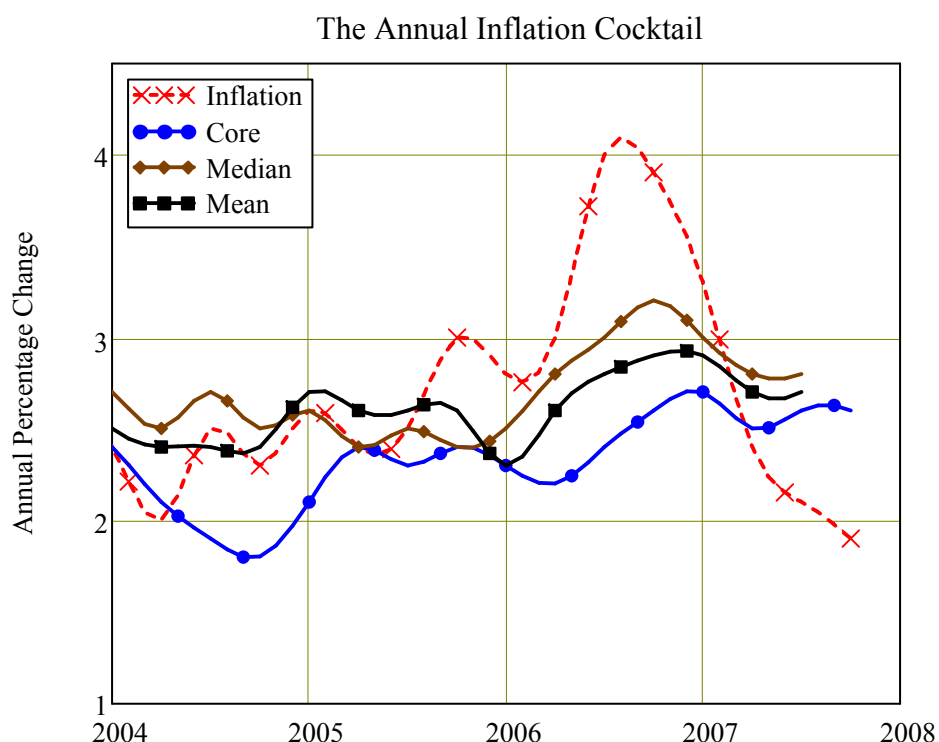
I'll take a look at the data from the RBA's point of view, and then throw debt into the mix and see what happens.

1. Inflation

The RBA's key concern is that the rate of inflation seems to be increasing. Though the basic yearly CPI change shows a *decreasing* trend (the last six figures from June 2006 to September 2007 recorded annual rates of inflation of respectively 4.0, 3.9, 3.3, 2.4, 2.1 and 1.9%), the three measures the RBA pays the most attention to are the so-called "Core" (which excludes volatile items like petrol), the "weighted median" and the "trimmed mean" (which the ABS derives on the RBA's behalf from more detailed ABS data). These influential rates are shown in bold in Figure 3 below, while the conventional CPI inflation measure is shown as a dotted line.

Annual Inflation

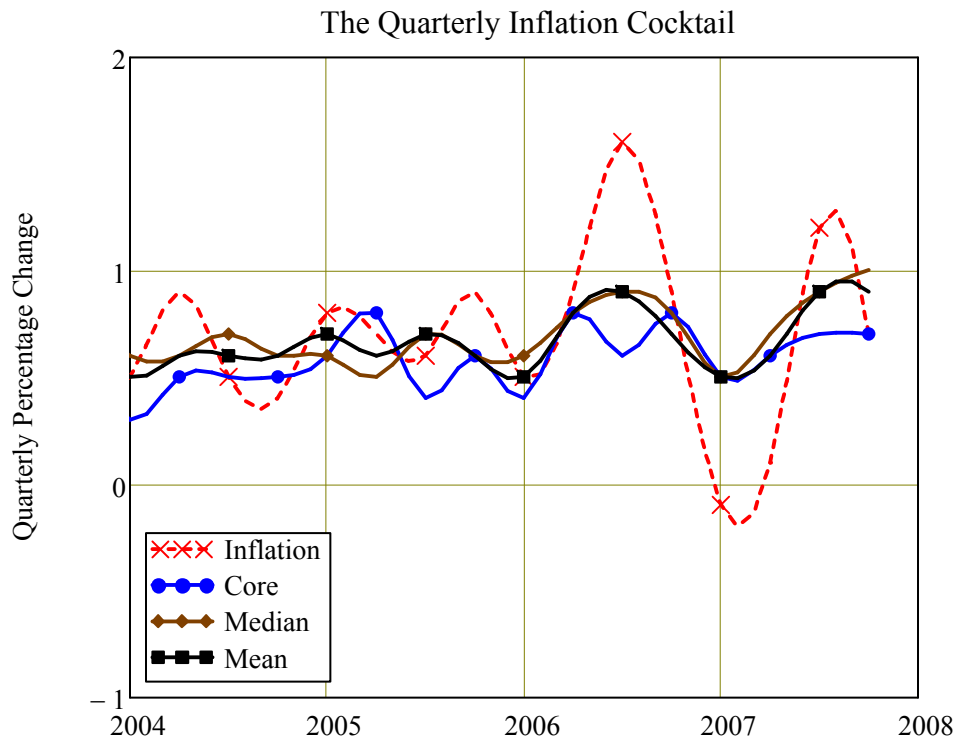
Figure 3



The annual rates--which are a moving sum of the previous four quarters--are all within the RBA's target zone of 2-3 percent (and as Peter Costello pointed out, the mandated target of the CPI is actually *below* the target zone--though 0.2 percent of that is directly attributable to changes in child care funding). The quarterly figures however are more volatile, the RBA's measures show an increasing trend as Figure 4 indicates, and a simple "multiply by four annualisation" implies a yearly rate of over 3 percent.

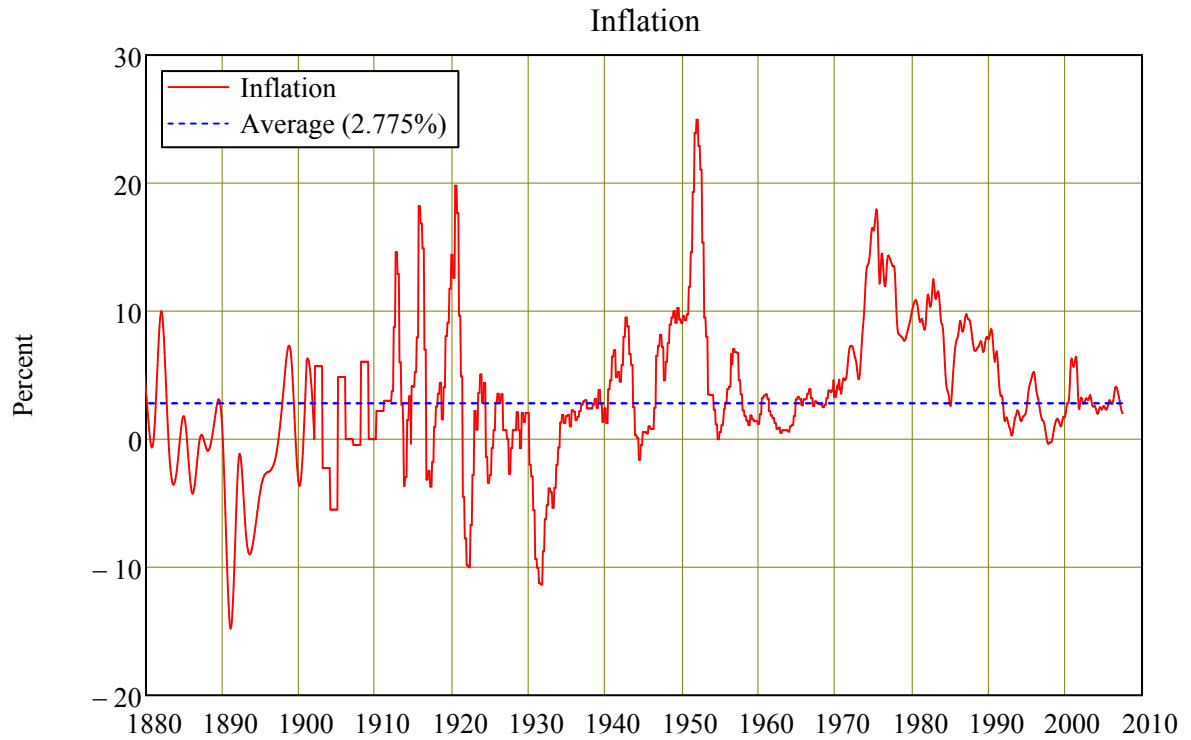
Quarterly Inflation

Figure 4



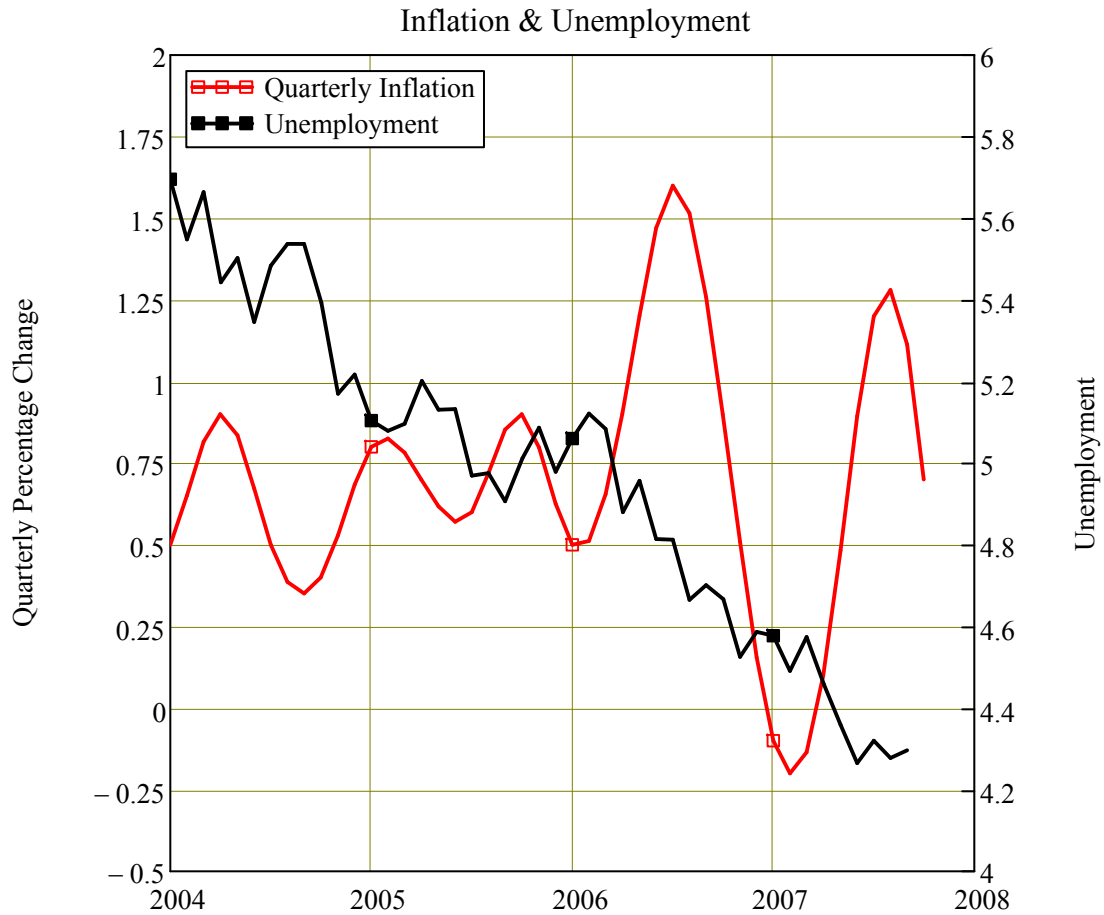
While a rate of inflation of about 4 percent might look like bad news compared to recent data, in the longer time scale, an annual inflation rate of that level is hardly scary. Figure 5 shows the really long term picture for inflation in Australia, which has varied radically over the last 150 years, from a low of *minus* 15% in the 1890s to a high of 25% in 1952. In terms of annual change to the CPI—which is the only measure we have that goes back more than 25 years—then we're currently smack on the long term average of 2.8% (using that simplistic "multiply by four" annualisation of the quarterly figure).

Figure 5



Nonetheless, a trend of increasing inflation, combined with a falling unemployment rate that indicates an "overheating" economy (see Figure 6), implies that the RBA will increase rates this week. Their mathematical models tell them that a slight tweak to the interest rate will "cool" the economy, thus reducing inflation, and enabling the current period of sustained economic growth to continue.

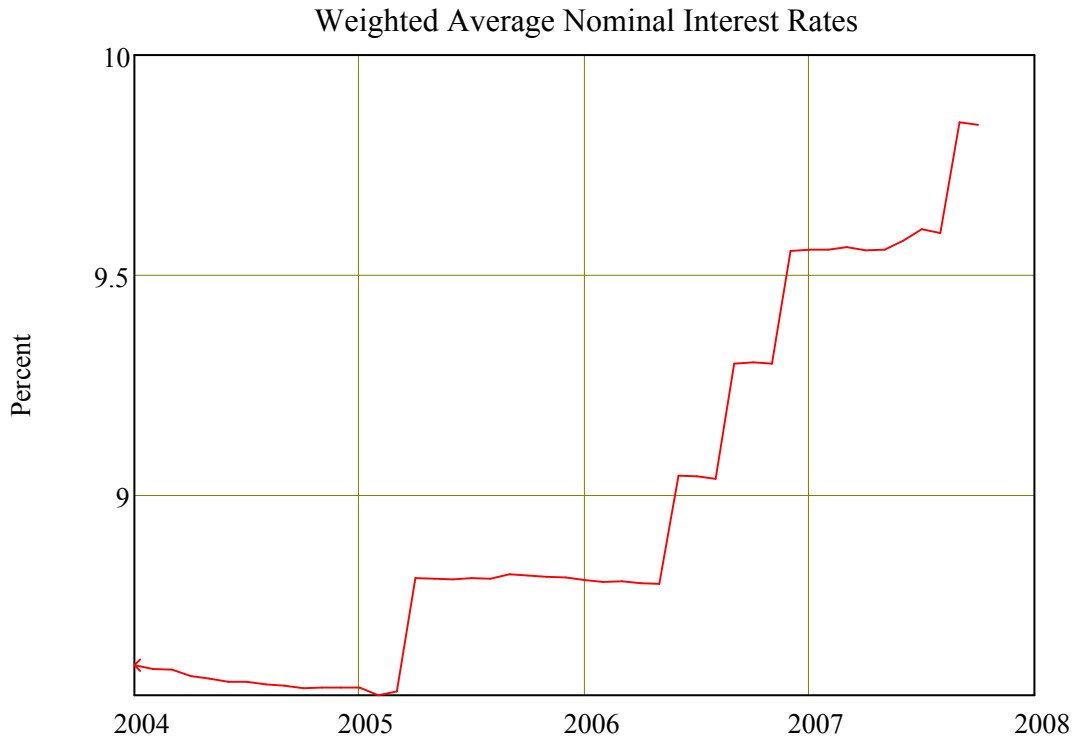
Figure 6



2. Interest Rates

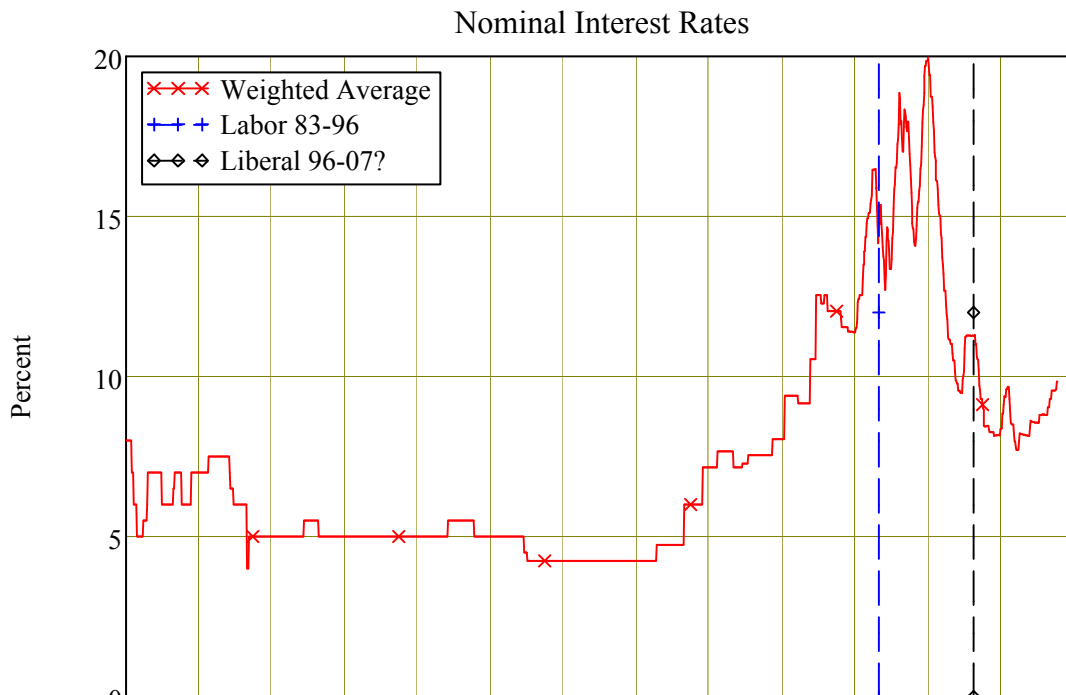
Interest rates have of course risen substantially in the last four years--both due to official rate rises and, more recently, an increase in spreads. As Figure 7 shows, the average rate is now 9.8%, and it would exceed ten percent if the RBA increased official rates this week--especially if, as is also expected, lenders further increase the spread in reaction to the continuing US subprime crisis.

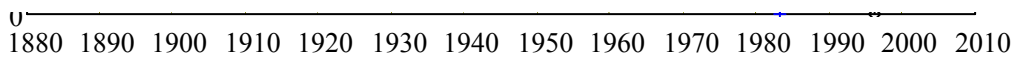
Figure 7



An average nominal rate of almost ten percent is on the high side, but, as Howard and Costello never tire of telling us, it doesn't compare to 1990 when it hit the highest in history, at 20 percent (see Figure 8). Figure 8 also shows that, despite the stick Howard and Costello are currently experiencing over interest rates, nominal rates are lower now than they were when the Liberals came to power in March 1996, and the average nominal rate of interest was lower under the Liberals than under Labor.

Figure 8





However, the real measure of the impact of interest rates on the economy is not the nominal rate, but the inflation-adjusted "real" rate--the difference between the rate of interest and the rate of inflation.

Here, some unconventional logic applies. Most economists treat inflation as always and everywhere a bad thing, but in some circumstances, inflation can make life easier. If inflation is high, then an apparently crippling rate of interest is actually fairly easy to service, since inflation drives up incomes faster than the interest rate increases debt. The "real interest rate" is then negative--it's as if you're being paid to borrow money.

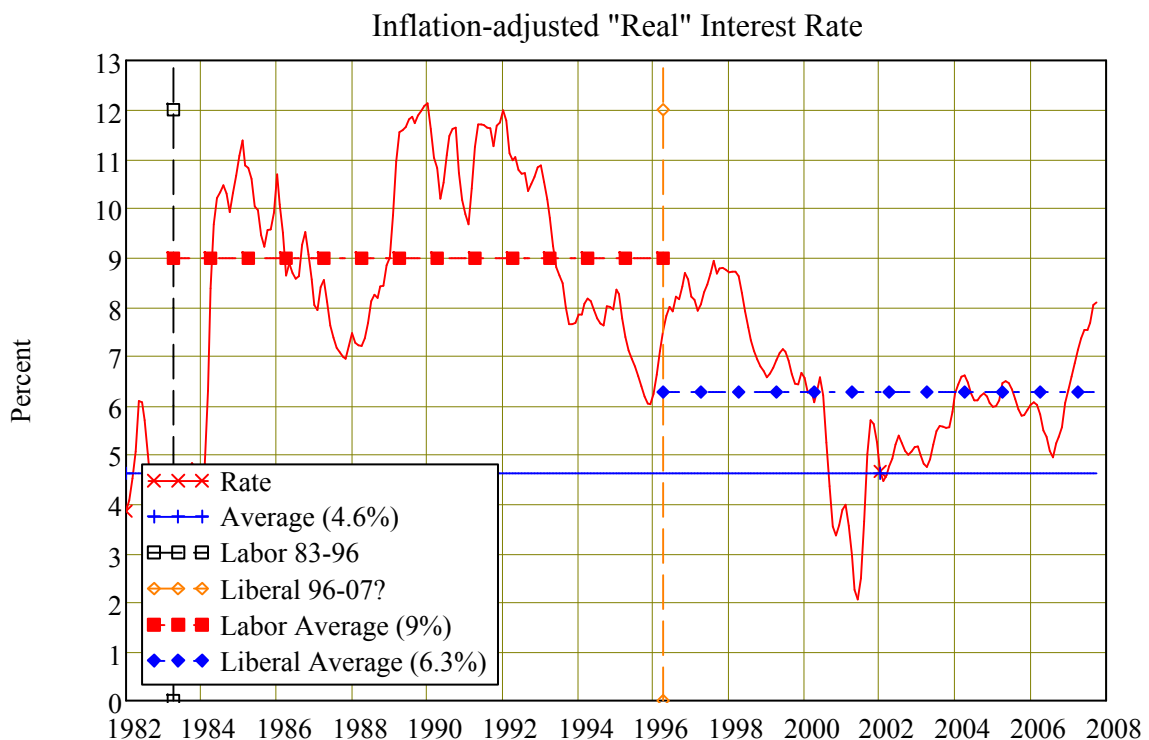
Discussing such a hypothetical might sound like like discussing the flight plan of a squadron of pigs, but in fact it has happened twice in recent memory--during the 1970s, and also from 1946 till 1953.

Conversely however, falling prices can turn a low nominal rate of inflation into a crushing debt repayment burden. This was why the Great Depression was so horrific, because prices fell by over ten percent per annum in 1931.

The inflation adjusted (or "real") rate of interest is thus radically different to the nominal rate. In 1952, when inflation hit 24% (courtesy of the Korean War), the real interest rate was **minus 20** percent. The real rate of interest in the 1890s, on the other hand, was 22 percent: far higher than the 12 percent level of 1990 (see Figure 9).

On this front, the real interest rate has also been lower under the Liberals than under Labor--though the most recent rate rise and the increase in risk spreads has recently returned the real rate to the near the average level for the Hawke-Keating years. At 8.1 percent, the current average real rate is also substantially above the long term average of 4.6 percent.

Figure 9



Given that the economy is apparently overheating, this higher real rate might seem justified as a means of stopping the boom getting out of control. And though it is high, it's still lower than it was under the Hawke-Keating Labor Government.

But there's still one more factor to consider--the level of debt--which, as Figure 2 made blindingly obvious, has never been as high as it is today.

3. Debt to GDP

The ratio has also virtually doubled during the term of the Howard Government, and it's increased by almost 30 percent since the last election (Figure 10).

Figure 10

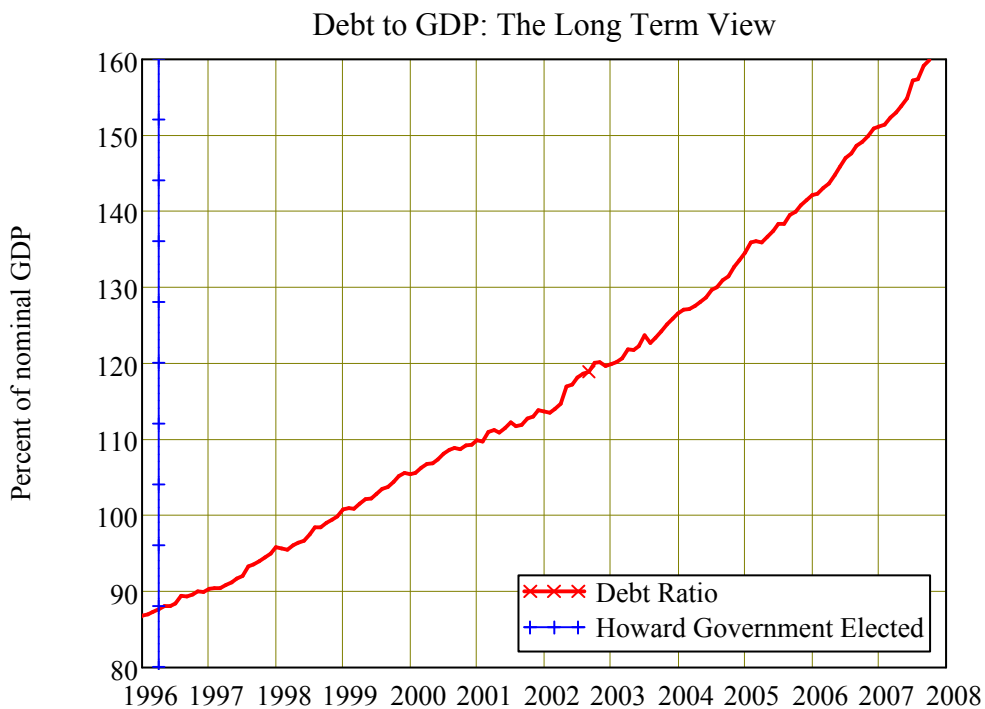


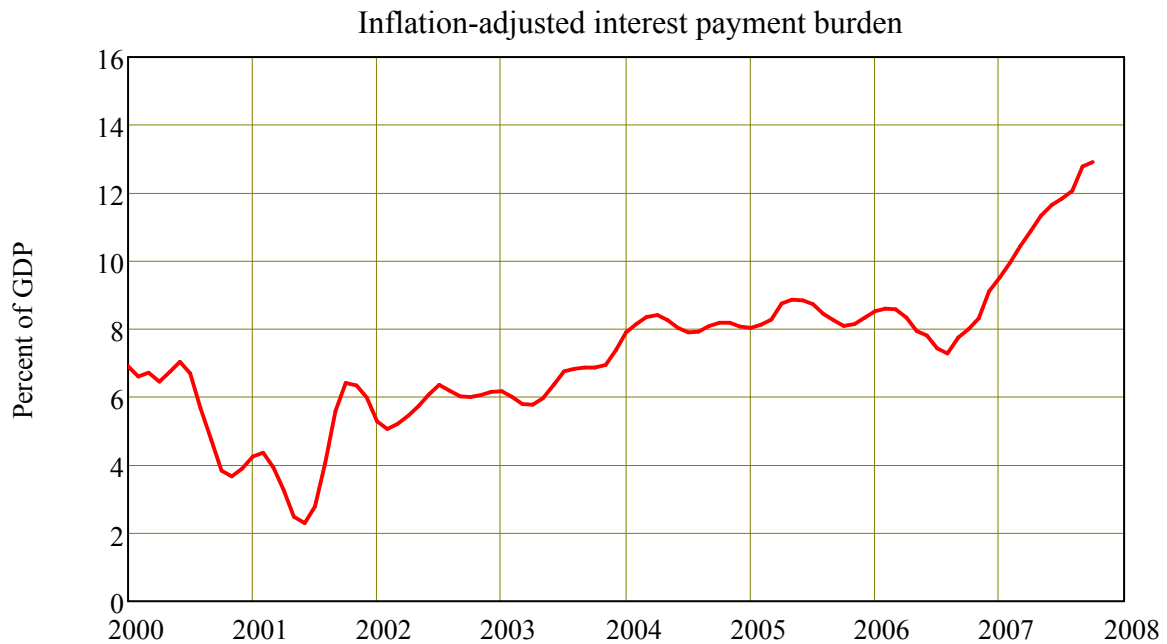
Figure 11 puts together all three factors:

- the interest rate
- the inflation rate; and
- the debt to GDP ratio

to calculate the real interest payment burden on the economy. This shows the percentage of real GDP that is needed to service debt. Its rapid rise since the last election may be the reason why Howard looks set to join John Hewson in losing "an unloseable election".



Figure 11



The next three tables break down the change in the real interest payment burden caused by changes in interest rates, inflation and the debt ratio. The dynamics give a nice illustration how, in a credit-money system, falling inflation can sometimes be a bad thing.

The real debt burden hit a low point in mid-2005, with a combination of a lower nominal interest rate (8.5%), a higher rate of inflation (6%), and a lower debt ratio (112%) than today. Since then, the 13% rise in nominal interest rates and 65% fall in the rate of inflation have conspired to cause a whopping 203% increase in the real (inflation-adjusted) rate of interest. On top of a 40% increase in the debt ratio, this has caused the real debt burden to rise by 325 percent in just six years (the last quarter's data isn't yet available, so this table stops in June 2007).

Table 3: Since Mid-2001

	0	1	2	3	4	5
T03 =	"Variable"	"Nominal Int."	"Inflation"	"Real Rate"	"Debt Ratio"	"Real Burden"
1	"Start Date"	2001.5	2001.5	2001.5	2001.5	2001.5
2	"End Date"	2007.5	2007.5	2007.5	2007.5	2007.5
3	"Start Value"	8.5	6	2.5	112.1	2.8
4	"End Value"	9.6	2.1	7.5	157.1	11.8
5	"Change"	1.1	-3.9	5	45	9
6	"Change %"	12.9	-65.6	202.8	40.1	324.3

The increase since the last election isn't quite that marked, but it is still enough to give as good an explanation as any as to why the electorate doesn't seem too fussed about dumping a team of "good economic managers". With a 12% rise in nominal interest rates, a 13% fall in inflation and a 25% increase in the debt ratio, the debt servicing burden has risen 45% since the last election.

Table 4: Since 2004 Election

	0	1	2	3	4	5
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	0	1	2	3	4	5
T04 =	"Variable"	"Nominal Int."	"Inflation"	"Real Rate"	"Debt Ratio"	"Real Burden"
	1 "Start Date"	2004.8	2004.8	2004.8	2004.8	2004.8
	2 "End Date"	2007.5	2007.5	2007.5	2007.5	2007.5
	3 "Start Value"	8.6	2.4	6.2	132.6	8.2
	4 "End Value"	9.6	2.1	7.5	157.1	11.8
	5 "Change"	1	-0.3	1.4	24.5	3.6
	6 "Change %"	12.2	-13.2	22	18.5	44.6

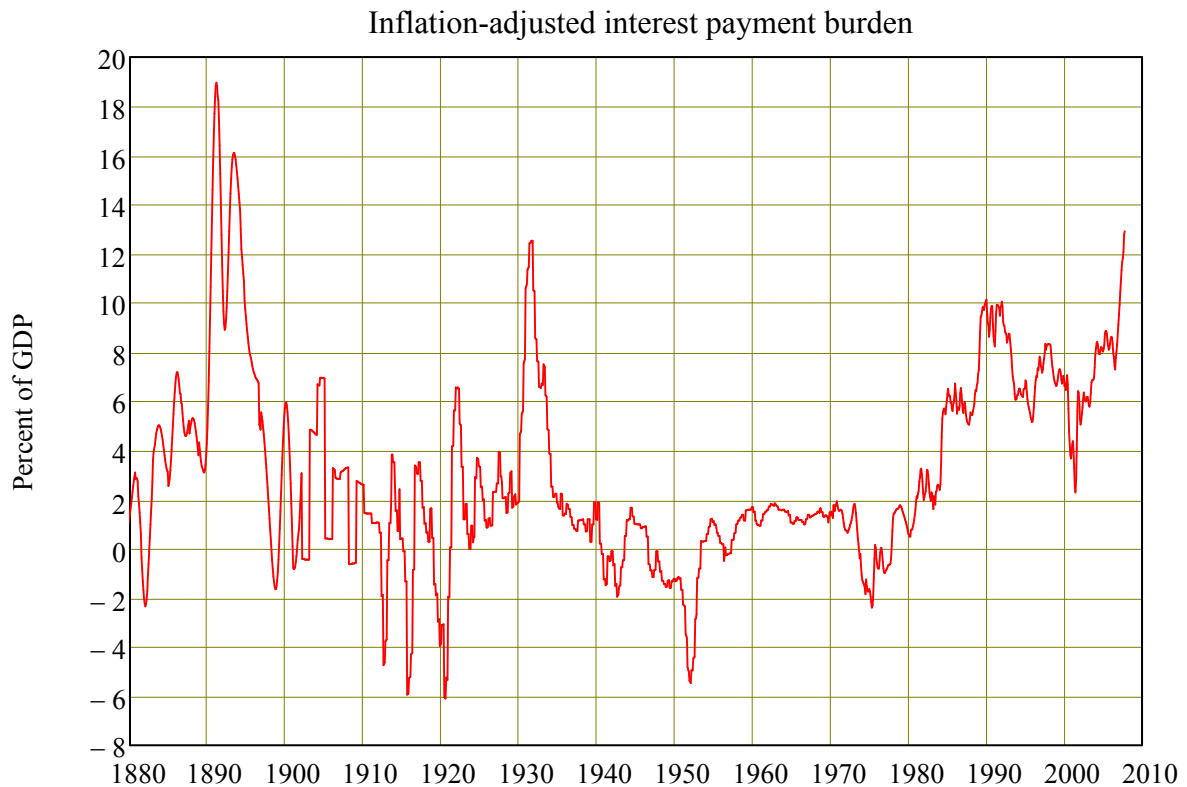
It has risen by 80% over the term of the Howard Government, with most of that increase contributed by a rise in the debt to GDP ratio (the fall in nominal interest rates was largely neutralised by the fall in the rate of inflation). It's no wonder that a majority of the electorate seems to regard "relaxed and comfortable" as **so** last year.

Table 5: Since 1996 Election

	0	1	2	3	4	5
T05 =	"Variable"	"Nominal Int."	"Inflation"	"Real Rate"	"Debt Ratio"	"Real Burden"
	1 "Start Date"	1996.3	1996.3	1996.3	1996.3	1996.3
	2 "End Date"	2007.5	2007.5	2007.5	2007.5	2007.5
	3 "Start Value"	11.3	3.7	7.5	87.6	6.6
	4 "End Value"	9.6	2.1	7.5	157.1	11.8
	5 "Change"	-1.7	-1.7	0	69.5	5.2
	6 "Change %"	-14.7	-44.7	0.2	79.4	79.7

Relaxed and comfortable may in fact be "so last century". The final chart in this month's Debtwatch shows the really long term history of the real debt burden. It shows that the current debt burden is greater than at any time since the depths of the 1890s Depression

Figure 12



Conclusion

So the RBA should not raise rates. It should instead "sit on its hands", and be ready to drop rates rapidly should a debt-induced downturn begin.

This is what its US counterpart is doing already of course--since the signs of credit market dysfunctionality are more apparent there than they are in Australia (as yet, anyway). The Federal Reserve has reduced its rate by 3/4rs of a percent in the last two months--a substantial change in the opposite direction. I don't often argue that Australia should follow the lead of the USA, but this is one time when I would prefer a certain amount of "Me-Tooism" in monetary policy.

Note:

The above research is based on data supplied by the RBA from Ric Battellino's speech, and RBA Research Discussion Paper RDP1999-06 "Two Depressions, One Banking Collapse", by Chay Fisher and Christopher Kent; and Table PC30-31, page 214 of *Australian Historical Statistics* (Fairfax, Syme and Weldon Associates, 1987), edited by Wray Vamplew. Subsequent tables and charts are derived from the RBA Statistical Bulletin. The 1890 and 1930 peaks shown here exceed those in Battellino's speech, because his graph only showed bank credit prior to 1953; I have imputed total credit from Fisher and Kent's research into credit shares.

Aggregate Data and Trend Growth Rates

I am only providing a smattering of my usual graphs below these tables, since I published the normal set when the update to the RBA Statistical Bulletin occurred last month. I hope to organise these rather better over the Xmas period, and also link them to data tables that will be accessible from my blog (www.debtdeflation.com/blogs). For the meantime, I'm including just a sample of pertinent charts: the debt burden chart (which shows we're rapidly approaching the peak levels of the 1990s in terms of nominal interest payments--of course as I show above, we've gone well past 1990 in terms of the real burden); charts on the distribution of income, which continues to tip further and further into the pockets of the financial sector; and charts emphasising just how dependent aggregate demand now is on increasing debt.

Table One: Aggregated Debt Summary

Table One

	0	1	2
0	"Summary"	"Total Private Debt"	"Nominal GDP"
1	"Date (levels)"	2007.75	2007.5
2	"Levels (\$m)"	1703964	1045708
3	"Change Month \$m"	18714	6952.02
4	"Change Month %"	1.11	0.67
5	"Change Year \$m"	236448	79033
6	"Change Year %"	16.11	8.18
7	"Since 1990"	8.61	5.4
8	"Since 1980"	11.98	7.93
9	"Since 1964"	13.48	9.42
10	"Date (% GDP)"	2007.75	"N/A"
11	"As % of GDP"	159.8	100
12	"Change Month"	0.46	"N/A"
13	"Change Year"	7.23	"N/A"
14	"Since 1990"	2.92	"N/A"
15	"Since 1980"	4.11	...

$D_1 =$

Table Two: Disaggregated Debt Summary

Table Two

	0	1	2	3
0	"Detail"	"Business"	"Mortgage"	"Personal"
1	"Levels (\$m)"	661602	894459	147902
2	"Change Mth \$m"	12669	6476	-430
3	"Change Mth %"	1.95	0.73	-0.29
4	"Change Yr \$m"	126583	93104	16760
5	"Change Yr %"	23.66	11.62	12.78
6	"Since 1990"	4.96	14.7	5.48
7	"Since 1980"	10.62	14.03	10.45
8	"Since 1976"	11.16	14.3	11.23
9	"As % of GDP"	62.07	83.91	13.88
10	"Change month"	1.31	0.1	-0.92
11	"Change year"	14.24	3.12	4.19
12	"Since 1990"	-0.78	9.22	-0.38
13	"Since 1980"	3.01	6.03	2.62
14	"Since 1976"	3.07	5.78	2.99

$D_2 =$



