Steve Keen's DebtWatch No 20 March 2008
Double or Nothing?

The revelation in the minutes of the RBA's February meeting that debate focused, not on whether there should be a rise, but on whether it should be 0.25 or 0.5 per cent, shows that the RBA wagers that the threats to the Australian economy are upside ones--tighter labor markets and higher inflation--rather than downside ones--a global slowdown as asset markets collapse during a credit crunch. The February minutes implied that the RBA might really throw its cards on the table at the March meeting, with a 0.5% rise being a distinct possibility

This is in stark contrast to the biggest gambler in the regulatory stakes, the US Federal Reserve. Not only did it drop US rates down by 1.25% last month, it is now signalling another 0.5% fall during March.

So which regulatory gambler is right--or, against the odds, are they both right? The answer depends on just how big a threat the current financial market turmoil poses to the global economy, and how well Australia is prepared to weather any storm this might cause.

A key issue for the former point is the size of the current financial bubbles, in both America and Australia. They are obviously bursting now, and the amount of pain that a bust can inflict clearly depends on how big the bubble itself was.

On that point, the answer is simple for the USA: the ***USA's recent bubble was the biggest in world financial history.***

Robert Shiller, the man who coined the phrase "irrational exuberance", makes that clear in the 2005 update to his book, where he compares American house prices and stock market indices to the CPI.

Houses are normally purchased on credit, and while an individual can pay back his or her mortgage debt by selling the house to someone else, society as a whole can't do that. Ultimately therefore, an economy's mortgage servicing has to be financed from its income, which is derived from selling goods and services. The ratio of asset prices to consumer prices gives the best measure of how hard or how easy that is to achieve. While there is no obvious "magic number" for the ratio (and the servicing cost of debt will rise and fall with changes in interest rates), its level tells us how sustainable house prices are at any point in time. A low ratio implies very affordable housing; a high one implies very expensive housing--and one that towers over the long term average implies a bubble.

A similar observation applies to the Stock Market. Though the Price to Earnings (PE) ratio is a commoner measure of the veracity of the Stock Market's valuation, earnings can be inflated by tricks ranging from outright fraud, to fancy "financial engineering", to debatable revaluations of assets--something that is becoming painfully obvious as the dominoes fall in the current Australian and US stock market slumps.

No such problems apply with the CPI, and since earnings have to come from sales of goods and services, the comparison of the asset index to the CPI gives a better idea of how sustainable the share market's prices are.

These calculations gives the lie to Greenspan's assertion that a bubble can only be identified after it has burst.

The US House Price Bubble

The bubble in US housing prices is obvious: between 1892 and 1995, the average for this index was 103, while its prevous peak value--set over a century ago in 1894--was 133.6.

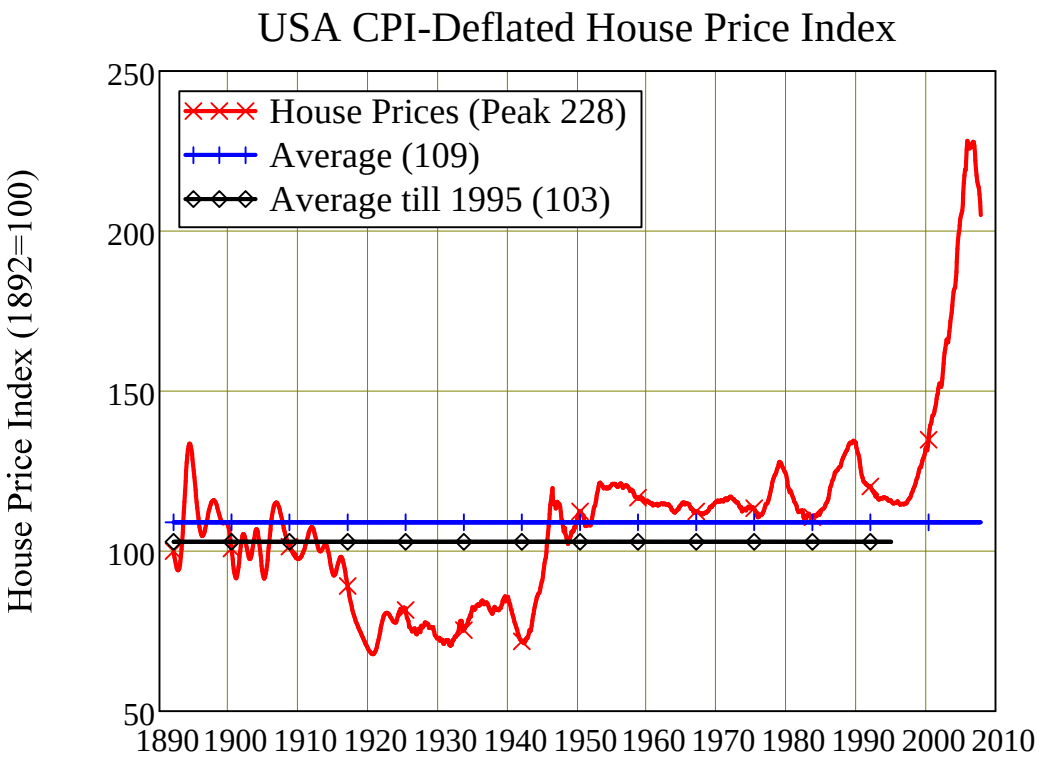
This long run maximum was breached in 1989, two years after Greenspan took over as Federal Reserve chairman, after he "rescued" Wall Street after the 1987 Stock Market Crash--a rescue which simply transferred the Wall Street bubble into a Main Street one, in commercial and residential property.

The property market crash in 1989 ushered in the 1990s recession that helped Clinton come to power. House prices still hadn't returned to the historic norm before the next boom began--fuelled by and feeding into the euphoria over the Internet. The housing bubble continued even after the Stock Market bubble temporarily burst, until it peaked in 2004 at 228, over twice the historic norm, and 70% above the highest level the index had reached over a century earlier.

If the index reverts to anything like its historic norm, then US house prices have much further

to fall. Even now, after a ten percent fall from its peak, *the index is still almost twice the pre-1995 long term average*. Commentators who are predicting a further 25% fall in US house prices may turn out to be optimists.

Chart One: USA Real House Prices



The US Stock Market Bubble

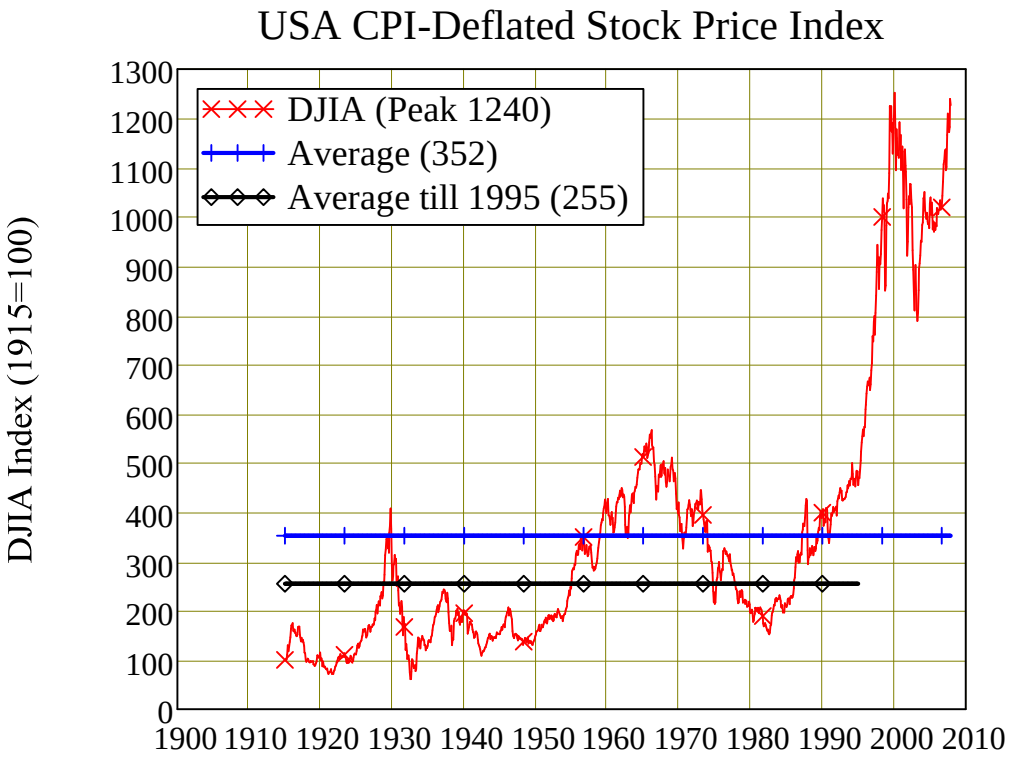
One intriguing fact that the deflated Dow Jones index reveals is that the previous biggest Stock Market bubble wasn't in 1929, but in 1966.

In 1929, the index reached an inflation-adjusted value of 407 (before collapsing to as low as 60 in 1932--an 85% fall). In 1966, the inflation-adjusted value of the Dow peaked at 567--after which it plunged for 16 years, to a low of 152 in mid-1982. This was a 73% fall in real terms.

Since then--with the dramatic exception of Black Monday in October 1987--it was all up until 2000. The Stock Market had already exceeded its Roaring Twenties peak by the time Greenspan took office in August 1987. Just two months later, it plunged back into near long-term territory with October 19th's 23% crash. Rather than the reversion to the mean continuing, the Greenspan Put emboldened the market, which sailed through the 1929 record in 1992, and kept right on going into an unprecedented level of overvaluation.

By 1996, it had left 1966 behind, and at the height of the Internet frenzy, it hit 1252--*almost five times the average that had prevailed up until 1995*. Then in 2000, just as Greenspan was reiterating his belief that a bubble can only be identified in its aftermath, the one he was riding burst.

Chart Two: USA Real Stock Prices



Quick rescue work by the Fed--both injections of liquidity, and dropping the reserve rate to 1%--and massive government deficits to finance the war in Iraq, turned the market's reversion to the mean around by mid 2003. By late 2007, it revisited its 2000 peak.

Then its recent plunge began.

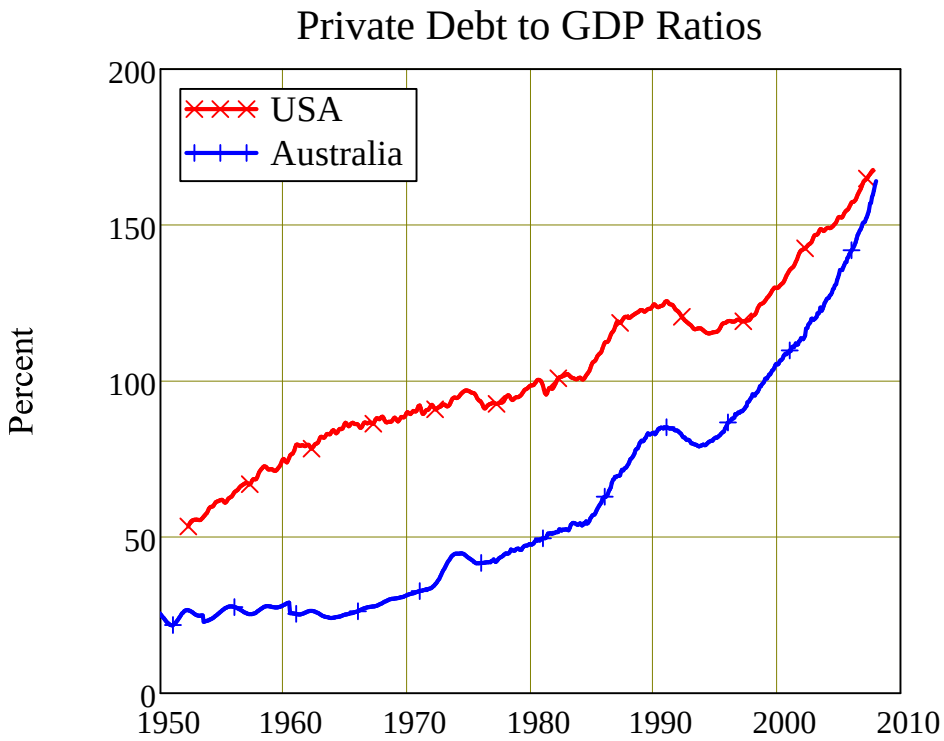
A more current value of this index must await the US CPI figures for January and February, but it must be of the order 1050 now. *Even so, this puts it at more than four times the pre-1996 average*.

Where could the index head to, if the market finally heads back to its historic norm? As the USA basked in the collective delusion of the Internet Bubble, some authors put out books with the titles *Dow 30,000*, *Dow 36,000*, and even *Dow 100,000* (Zuccaro; Glassman, Hassett & Hassett; and Kadlec; look for them in the remainder bins of your local bookshop). On this data, Dow 3,000 looks more the go.

Of course, it is also possible that the bubble could re-form--but that would require a renewal of the trend for an ever-increasing debt to GDP ratio, since leverage is what has driven house and share prices to their current levels.

This is possible, but unlikely, for the same reason that a similar "solution" is unlikely here: America's debt to GDP ratio is already at record levels. Even if the Fed drops official rates to zero (as Japan's Central Bank did during the '90s), and average commercial interest rates drop to three per cent, the debt servicing burden on the economy will still be immense. And a cut in official rates won't rescue home buyers who have signed up for fixed interest loans, which are the norm in the US market.

Chart Three: USA vs Australian Private Debt Ratios



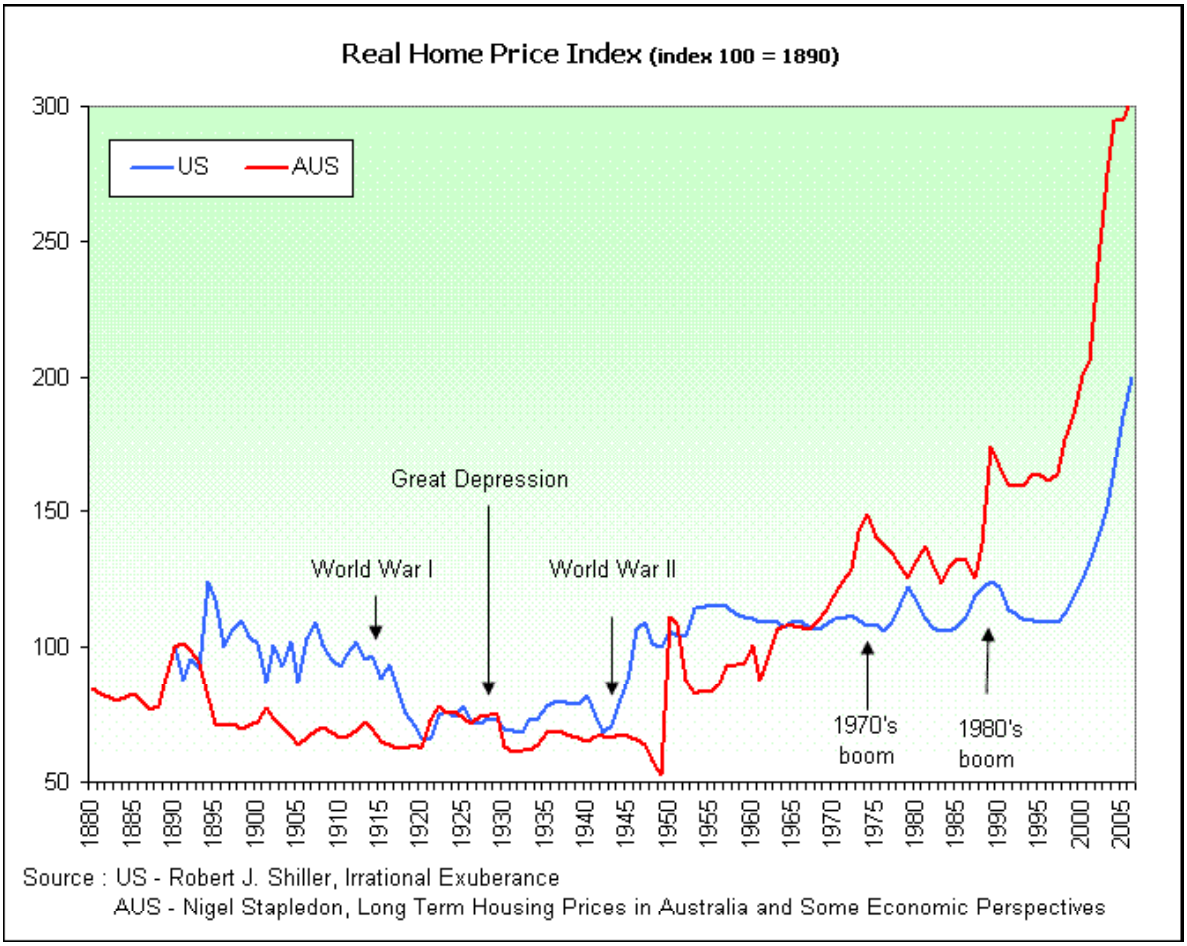
How Big Are Our Bubbles?

How do the Australian house and stock market bubbles compare to America's?

The bad news is that Australia's housing price bubble is at least 50% larger than America's. I currently lack really long term data for Australia, but Nigel Stapledon at the University of New South Wales provided the following perspective in his PhD thesis: (the following chart, which compares Stapledon's index for Australia to Shiller's for the USA, is taken from: http://www.whocrashedtheeconomy.com/?m=200801). Clearly, the Australian house price bubble dwarfs America's.

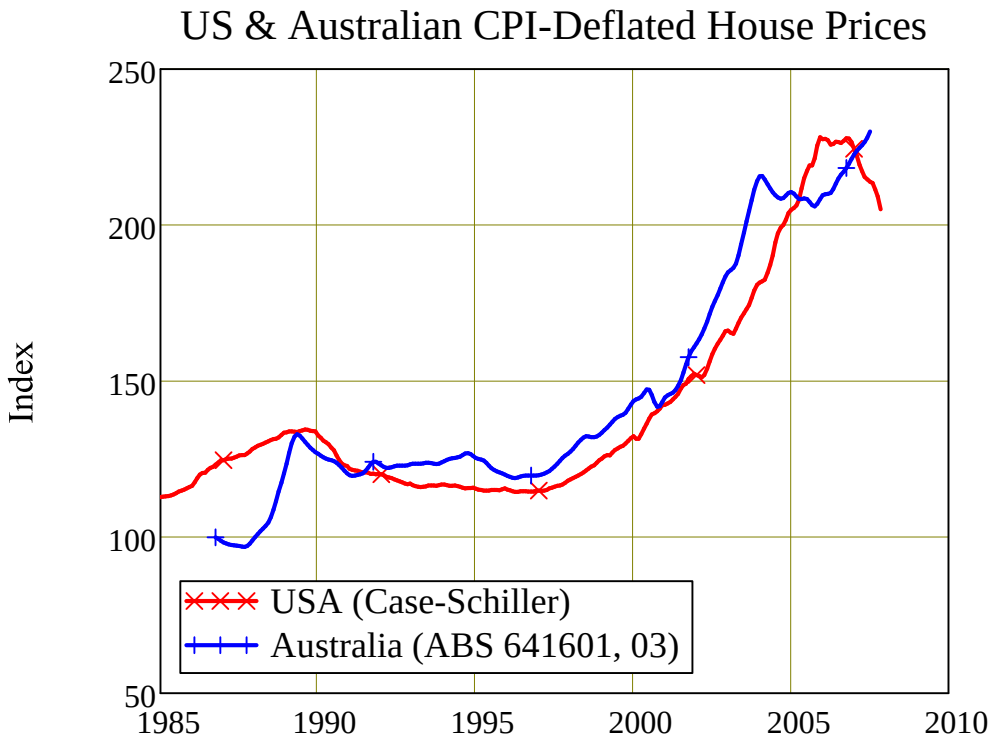
Some may wish to explain the divergence on the basis of real factors such as Australia's higher rate of population growth, etc. While these factors undoubtedly play some role, I very much doubt that they can explain the volatility shown in Stapledon's data. The two country's house price indices were virtually identical in the mid-1980s, for example, and then within a couple of years, Australia's was almost twice America's. We didn't take in that many more migrants then--nor could their influx explain a bubble focused on the middle to upper-range suburbs.

Chart Four: USA vs Australian Long Term Real House Prices



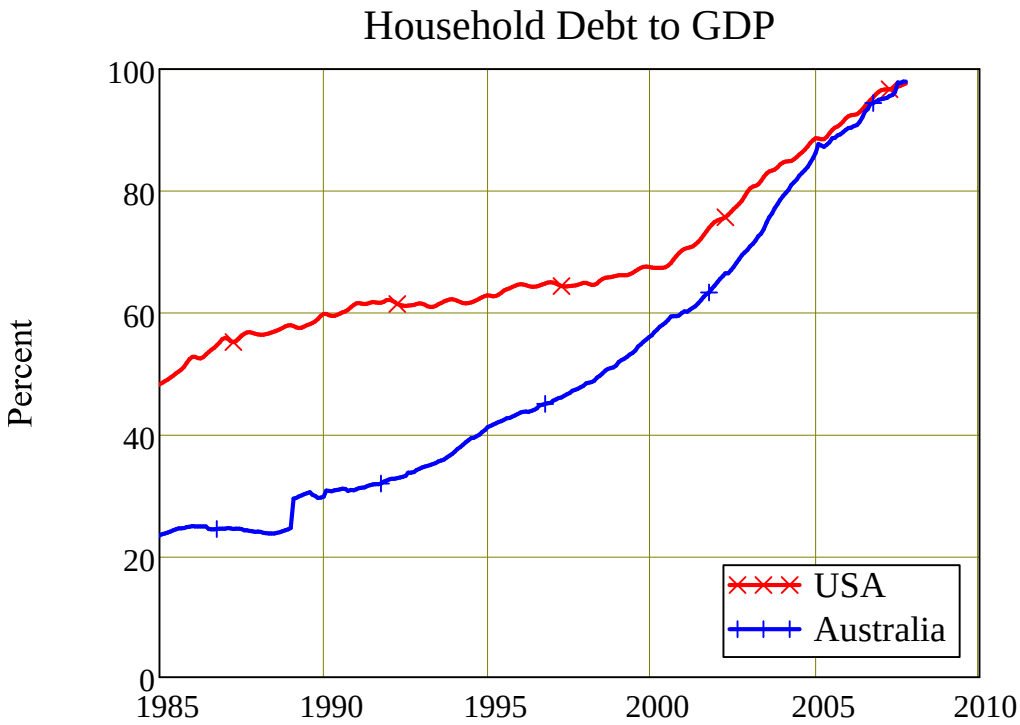
It's also apparent that Australian house prices have increased more than the USA's since 1987, and remain in a bubble today, while the USA's index has clearly turned.

Chart Five: USA vs Australian Recent Real House Prices



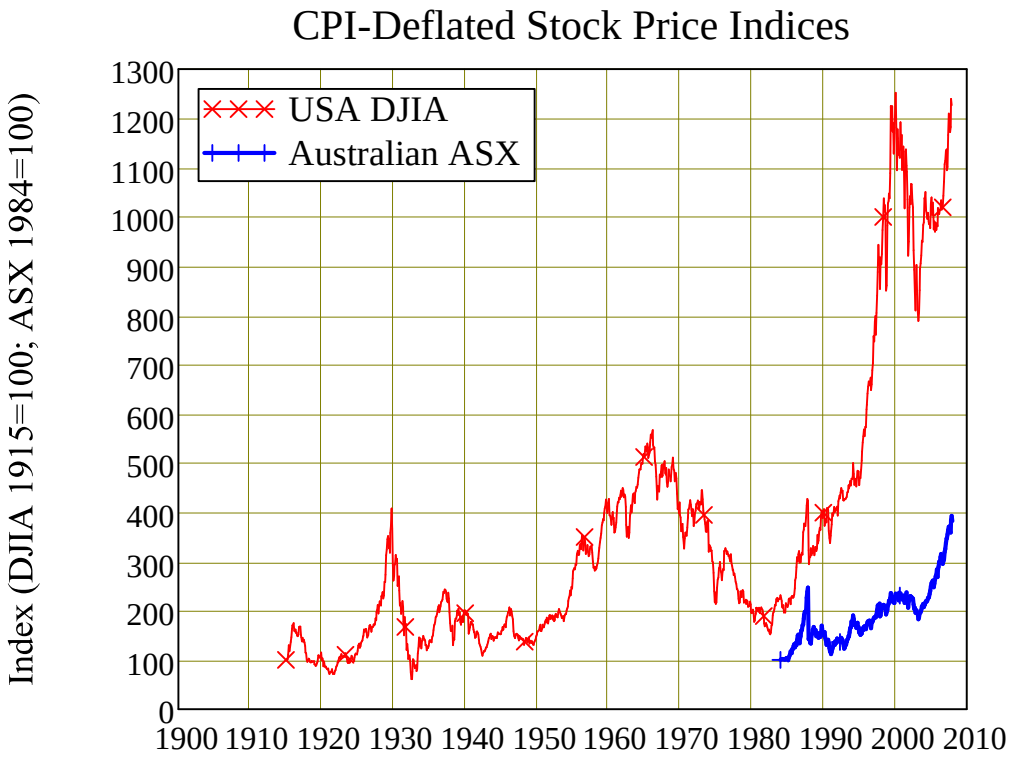
Given that our household debt to GDP level was half that of America's in 1990, but is identical now, I expect that the true explanation of Australia's greater housing bubble is financial, not "real". If so, we face just as serious a potential downside to house prices as does America, if not more so. The differences in outcomes to date may result from the China Boom, combined with the very different mortgage default laws in the two countries.

Chart Six: USA vs Australian Household Debt Ratios



So much for the bad news. The good news is that Australia's stock market hasn't been nearly as bubble-based as the USA's since 1987. In 1984 (when the ASX data begins), the CPI-deflated value of the Dow Jones was 2.3 times that of the ASX; by 2000, when the DJIA first hit its historic peak, the US index was 5.2 times the Australian one.

Chart Six: USA vs Australian Real Stock Market Indices



On the other hand, it's also apparent that its performance in the last four years has been *more* speculation-driven than the USA's. By time time both indices had peaked, the divergence between the USA and Australia had fallen to 3.2 to 1. It is likely that the recent obsession with margin lending as a "wealth enhancement strategy" has played a role here.

Chart Seven: USA vs Australian Stock Market Indices Trends

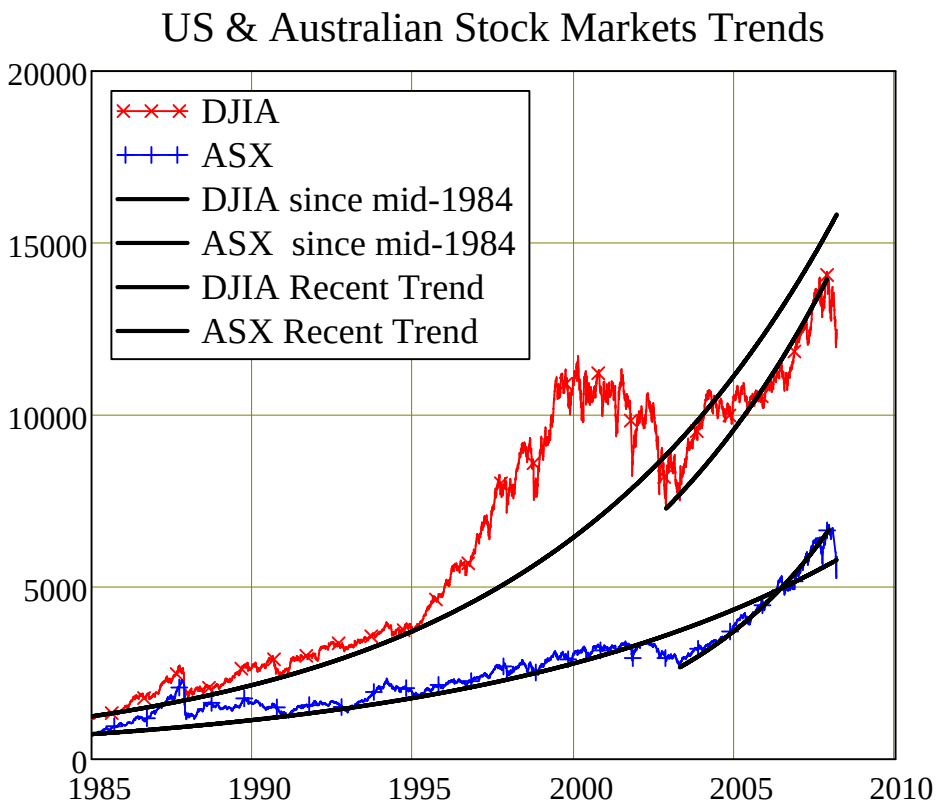
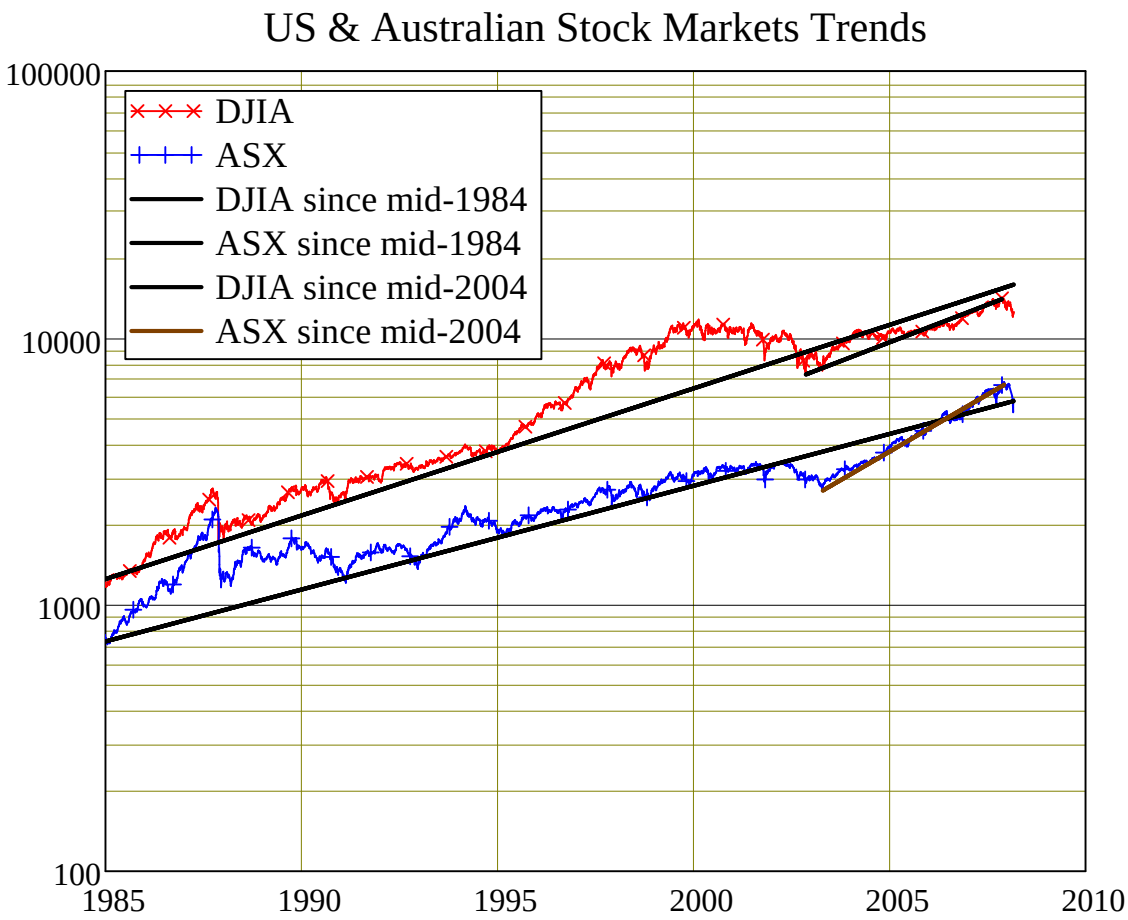


Chart Eight: USA vs Australian Stock Market Indices Trends



So which Regulator is "on the money"?

Neither the Federal Reserve nor the RBA deserves accolades for its management of the financial system. While they are diverging now over the threat posed by inflation, versus that emanating from systemic fragility, both have shared an obsession with keeping commodity price inflation under control, while asset prices and debt have spiralled out of control.

That said, the Federal Reserve clearly appears more realistic about the major threat facing the economy at the moment--even if that threat was fuelled by its own complacency during the greatest financial bubble of all time. Now is not the time to be fighting commodity price inflation, while ignoring both debt and asset price inflation.

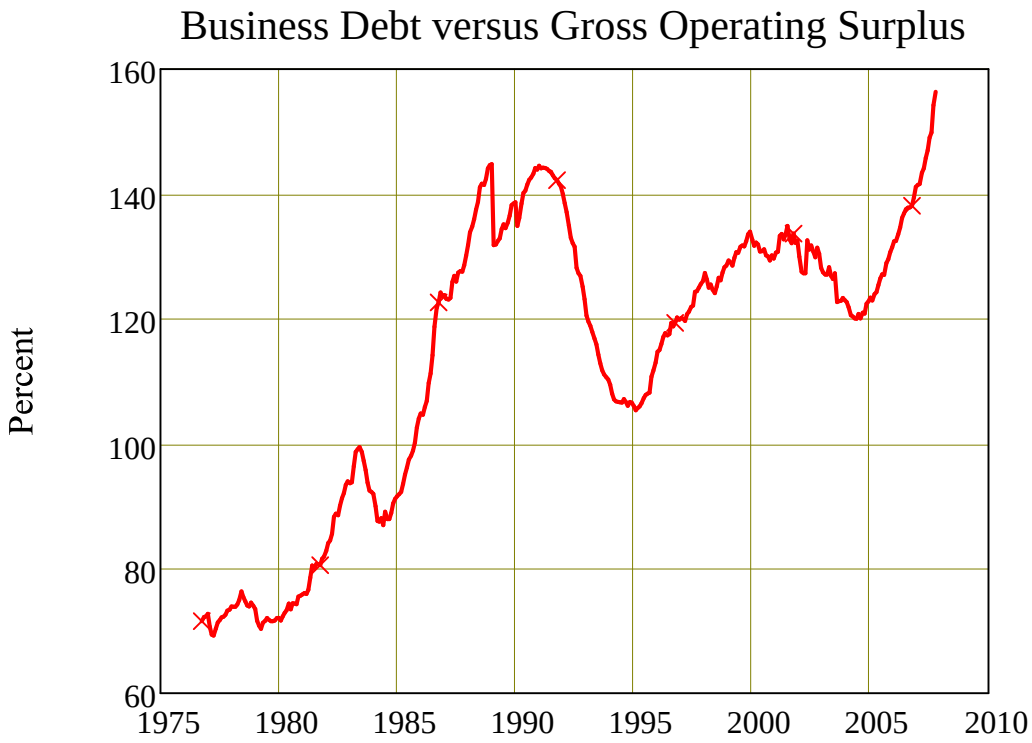
An aside: "Low" Business Leverage?

I've seen a number of media reports claiming that the current string of business defaults is unexpected, since business leverage is quite low these days.

That may well be true when debt to equity is the measure of leverage, but as I remark above, both asset prices (which determine the equity denominator in debt to equity calculations) and indeed earnings are rather rubbery figures.

A far better guide is to compare business debt levels to Gross Operating Surplus--the business component of national income. On that basis, the level of business gearing today substantially exceeds the previous peak set in 1990.

Chart Nine: Business Gearing



Of course, the debt servicing burden on business is much lower than in 1990, when the rate of interest was twice what it is now. But when a cash crisis hits, the rate of interest is irrelevant: what matters is the cash flow you have on hand to service debts as and when they become due. The current turmoil in our most heavily geared companies emphasises that point.