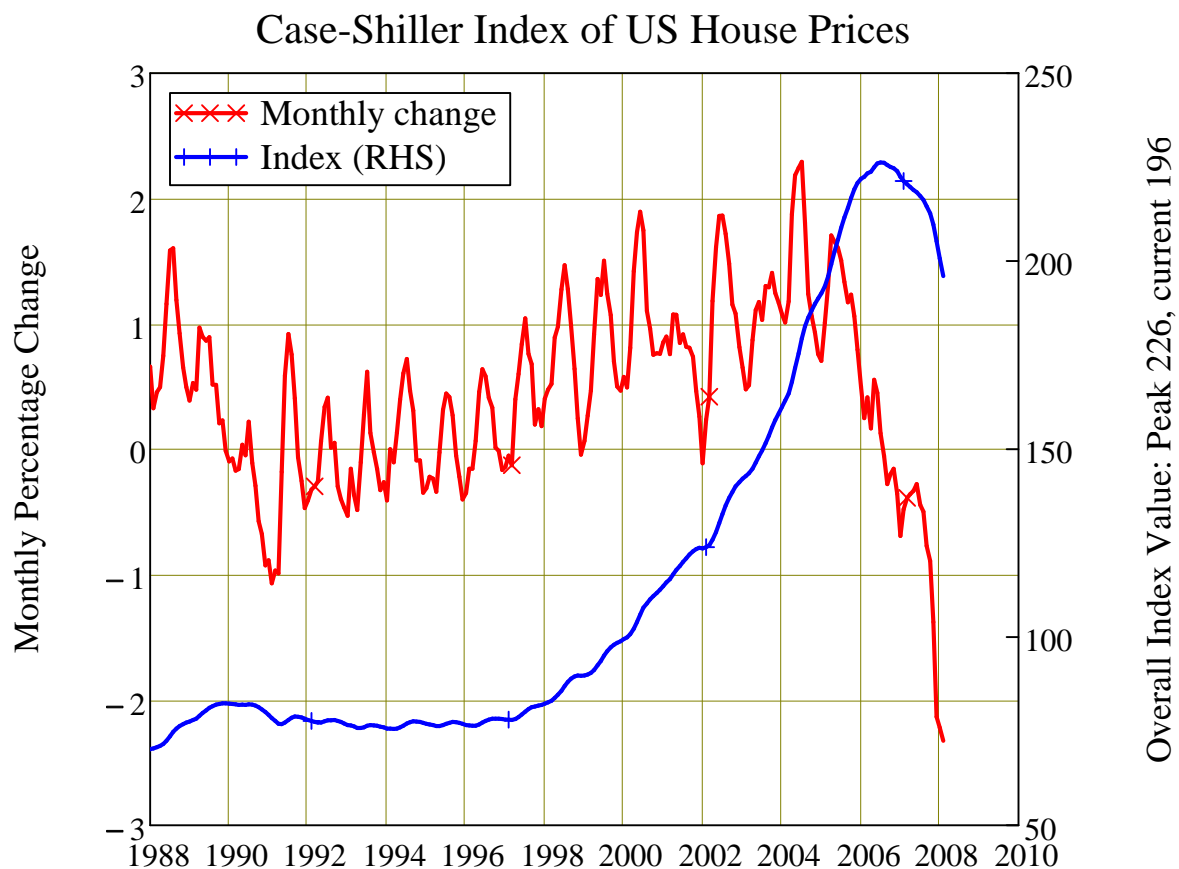


Steve Keen's DebtWatch No 21 April 2008 At Last, the 1975 Show?

My main topic this month is a comparison of the economic events of today to those of 1973-75, but the most recent Case-Shiller data on US house prices simply has to be "the Chart of the Month". Last **month** the index dropped by 2.3 percent--implying an annual rate of decline in the realm of 25%! US house prices are down 13% from the peak in mid-2006, and in free-fall now.

Chart of the Month: There goes the (US) Neighbourhood...

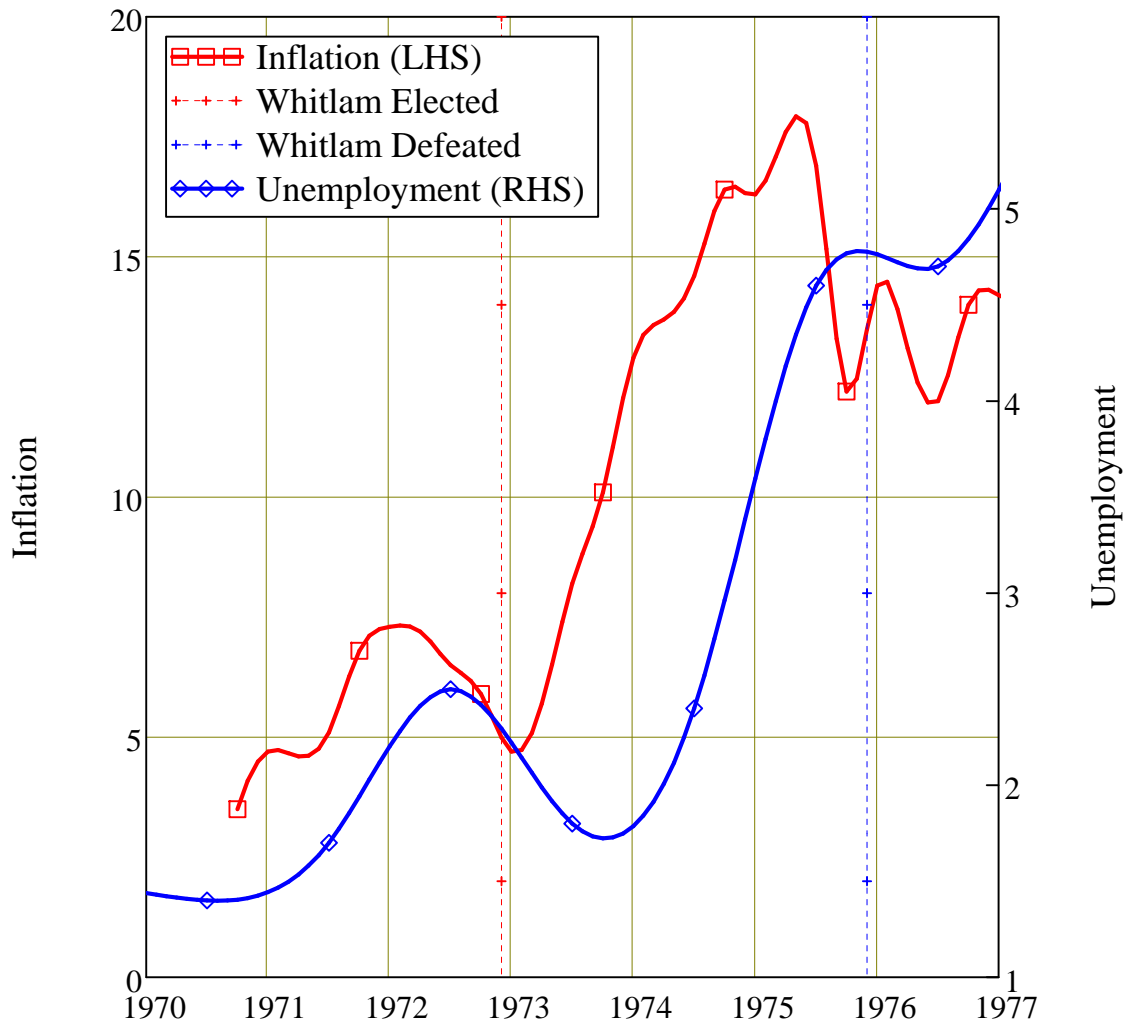


Meanwhile, back in the 1970s...

In late 1972, Whitlam's Labor defeated the McMahon's Liberals, and embarked on an ambitious program of social reform. Two years later, the economy had gone to hell in a handbasket. Inflation tripled from under 5 to over 15 percent, unemployment doubled from under 2 to over 4 percent, and Labor's reputation as an economic manager was ruined. Labor was slaughtered at the 1975 election, and "stagflation" was the paramount reason for its defeat.

In late 2007, Rudd's Labor defeated Howard's Liberals, and embarked on an ambitious program of social reform. Two years later...

The Standard Story: Stagflation

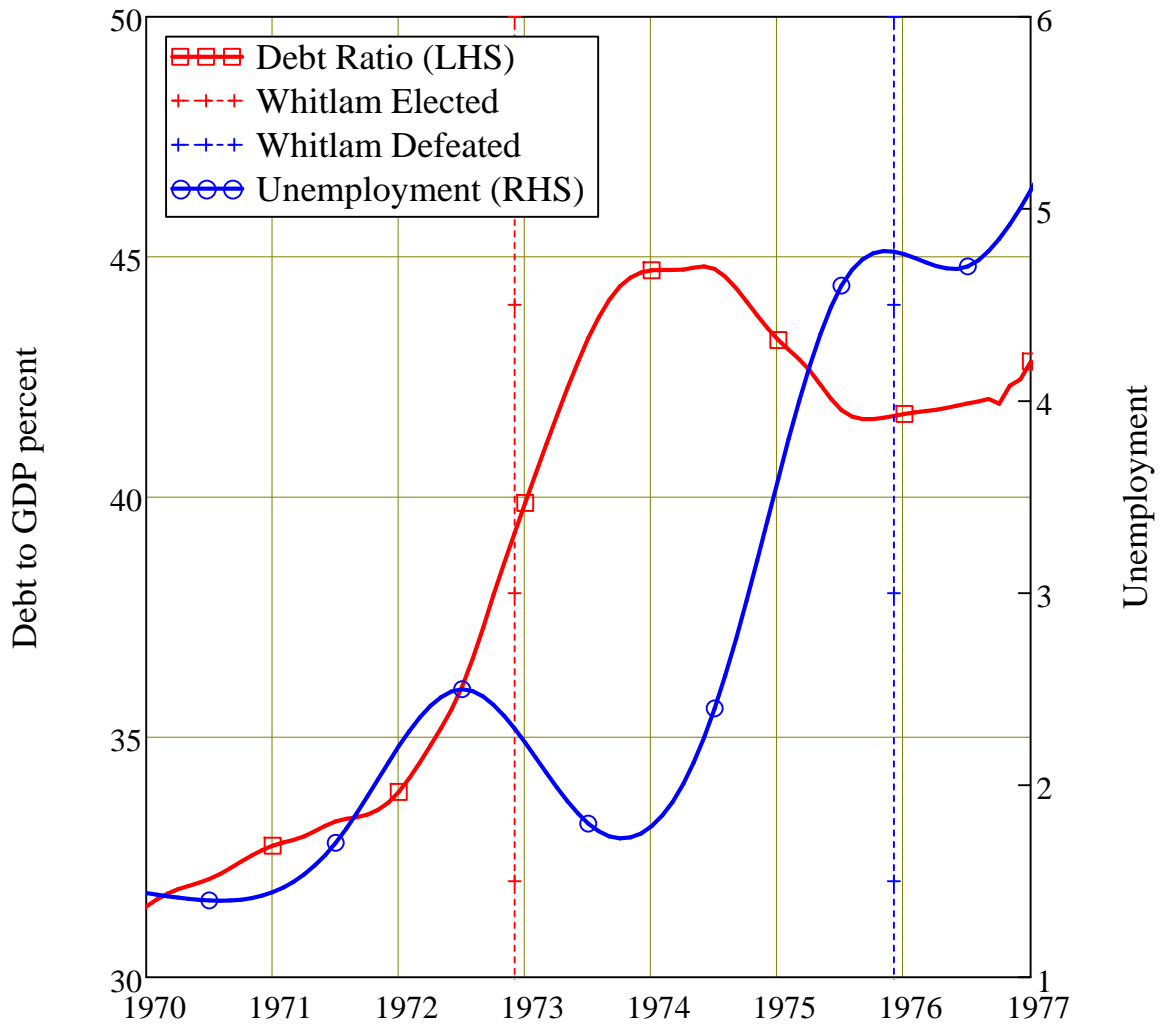


Will 1975 make a comeback? Some commentators see ominous signs, with a booming economy and rising inflation: will "stagflation" once again kill a Labor government? Clearly the Rudd Labor Government is determined to avoid this fate. A symbolic freezing of MPs' salaries was its second policy initiative after the opening of Parliament, while virtually every statement by Treasurer Swan emphasises fighting inflation.

However, identifying stagflation as the villain in 1975 may be a mistake. The real culprit was something entirely different, but strangely familiar: **the collapse of a debt-driven boom**.

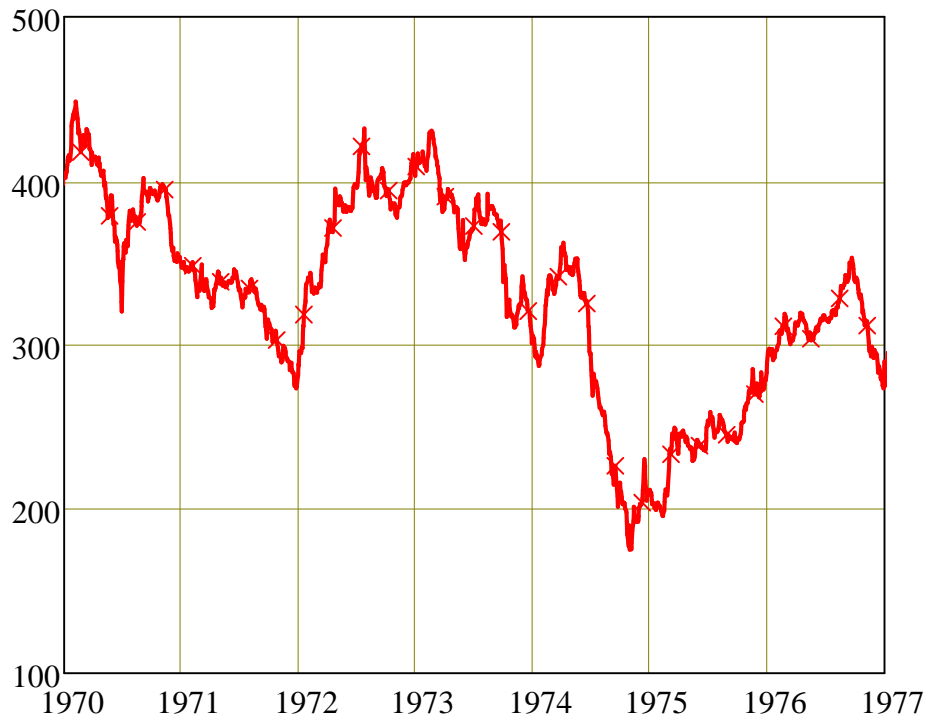
In 1972, the rate of growth of debt accelerated as a speculative boom (mainly in shares) took hold, and just two years later, the debt to GDP ratio had increased by almost a third. Unemployment, which had dropped from 2.5 to 1.7 percent as the boom accelerated, suddenly turned around, hitting 4.75 by the time Whitlam was turfed out of office.

The Real Story: Debt



The boom itself was short-lived, and in the context of an overall bear market since the Poseidon bubble of 1970. But it was followed by one hell of a slump, with share prices tumbling almost 60% in two years.

Sydney Stock Index: A bubble bursts

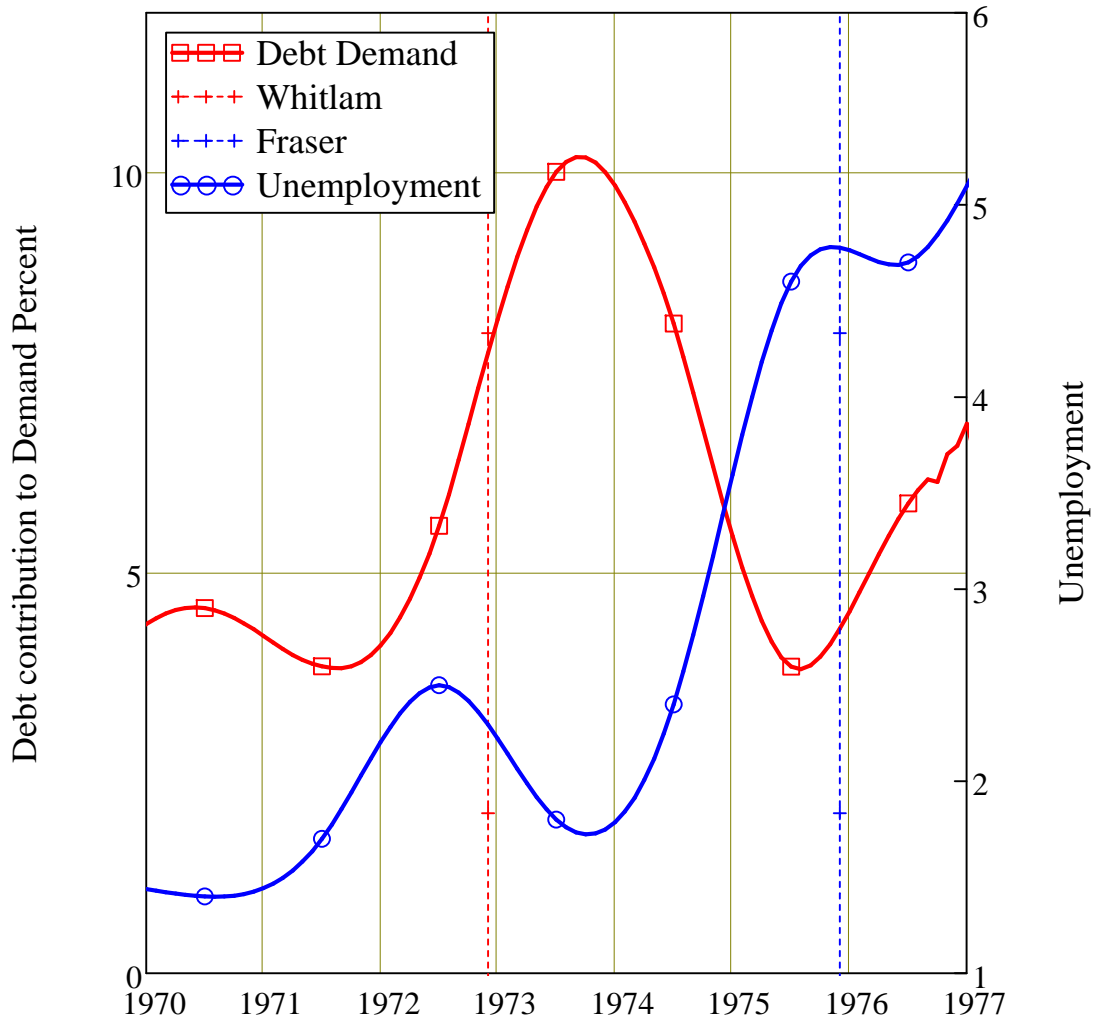


The engine behind the boom and its subsequent bust was the acceleration, and then sudden deceleration, in the rate of growth of debt. Aggregate spending in the economy is the sum of GDP **plus the change in debt**. With the boom of 1972-73, the change in debt went from providing under 3 percent to over 10 percent of demand.

Then the boom ended, debt went into reverse, and demand fell well below its previous peak.

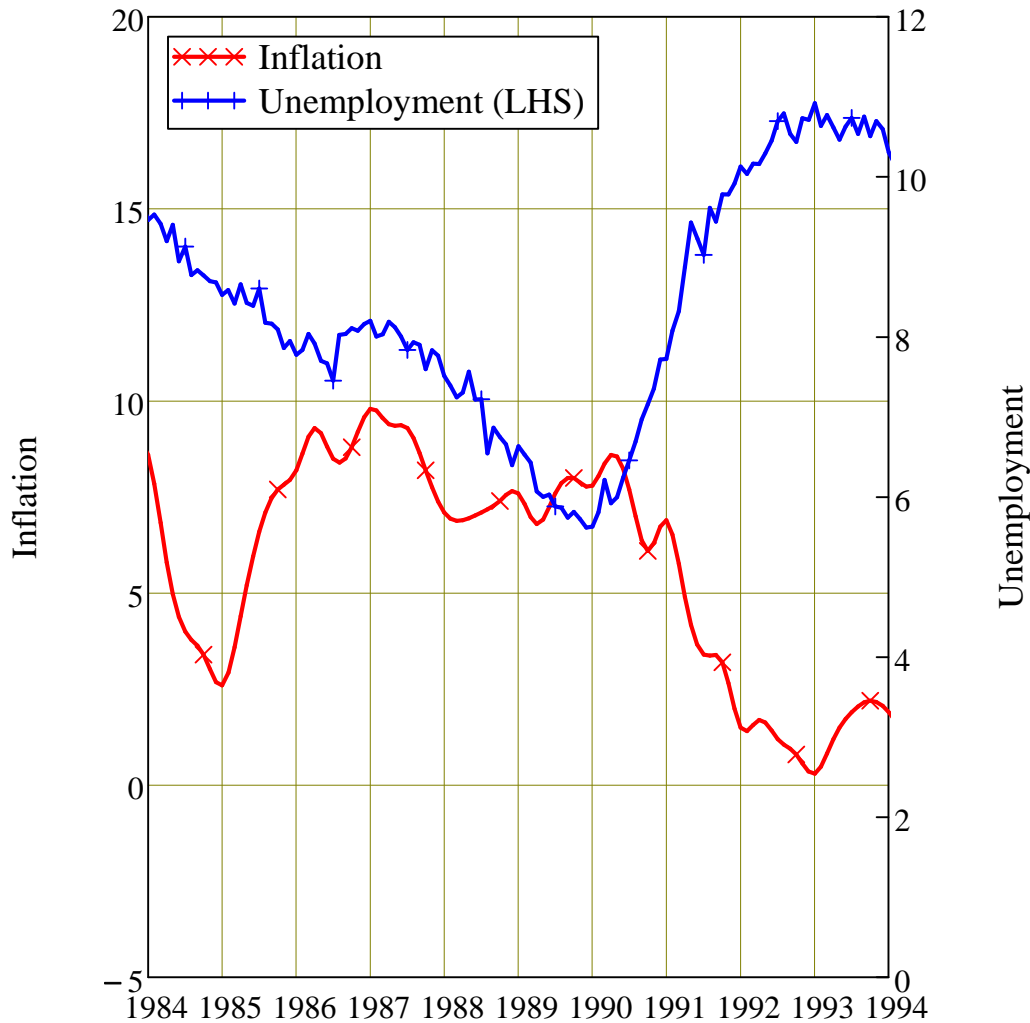
The collapse in debt gave us the "stag" in stagflation. The "flation" component came from a wages push in a *truly* fully employed economy (that 1.75 percent unemployment rate should put the recent celebration of "a 33 year low in unemployment" in perspective), and OPEC's oil embargo and price rises from October '73 to March '74. If the surge in inflation hadn't happened, then the downturn caused by the collapse in debt may well have been worse.

Debt's contribution to Demand



The same story played itself out again in 1990 when "the recession we had to have" hit our shores. This time, there was no pre-existing inflationary surge, and inflation fell drastically as the economy went into recession. So the inflation-unemployment story was very different to 1975.

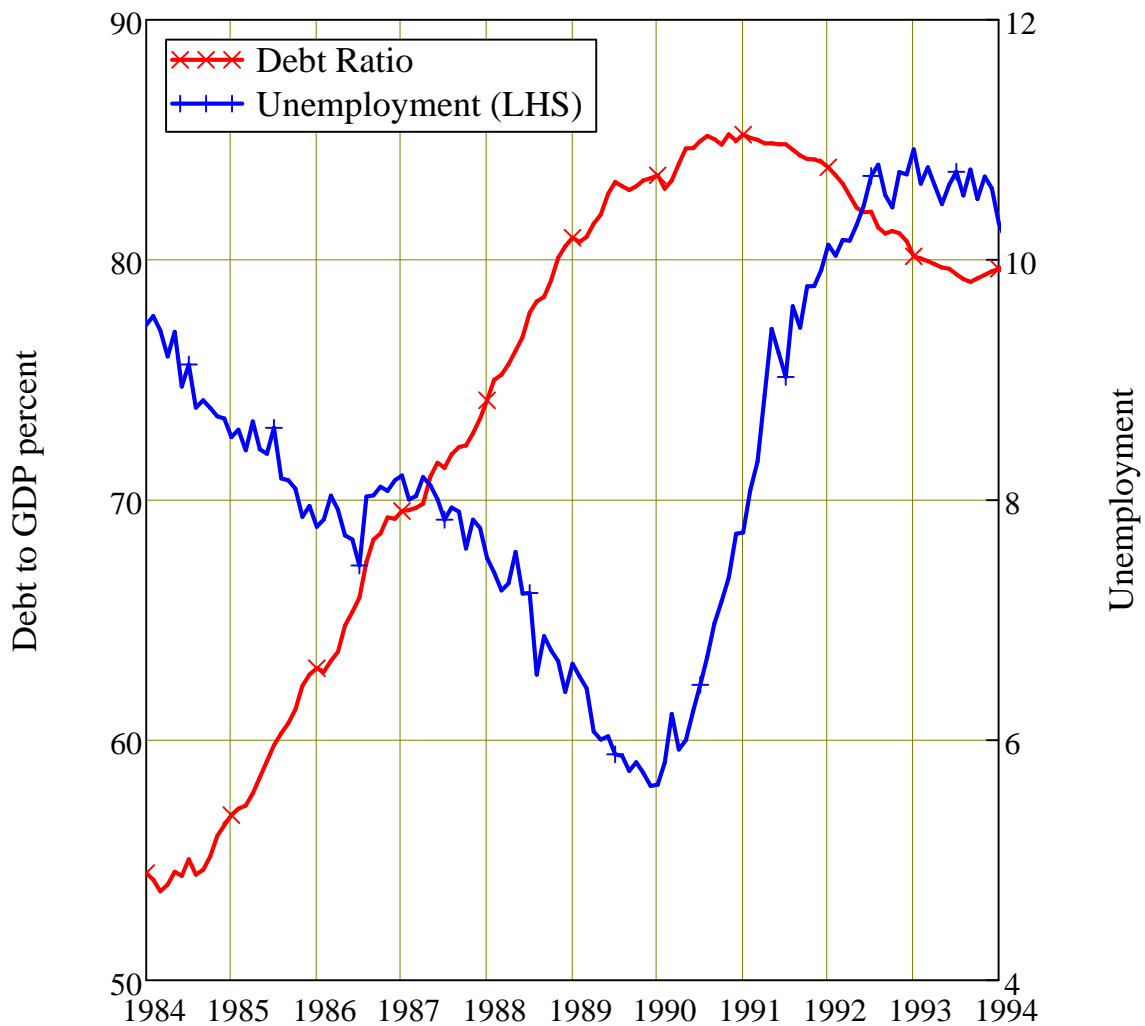
The Recession We Had to Have



The debt-unemployment dynamics, on the other hand, played to the same tune. The 1980s share and commercial property bubbles were debt-financed, and as debt levels accelerated from 54 to 85 percent of GDP (a rise of almost 60%) unemployment plunged from 9.5 to 5.6 percent.

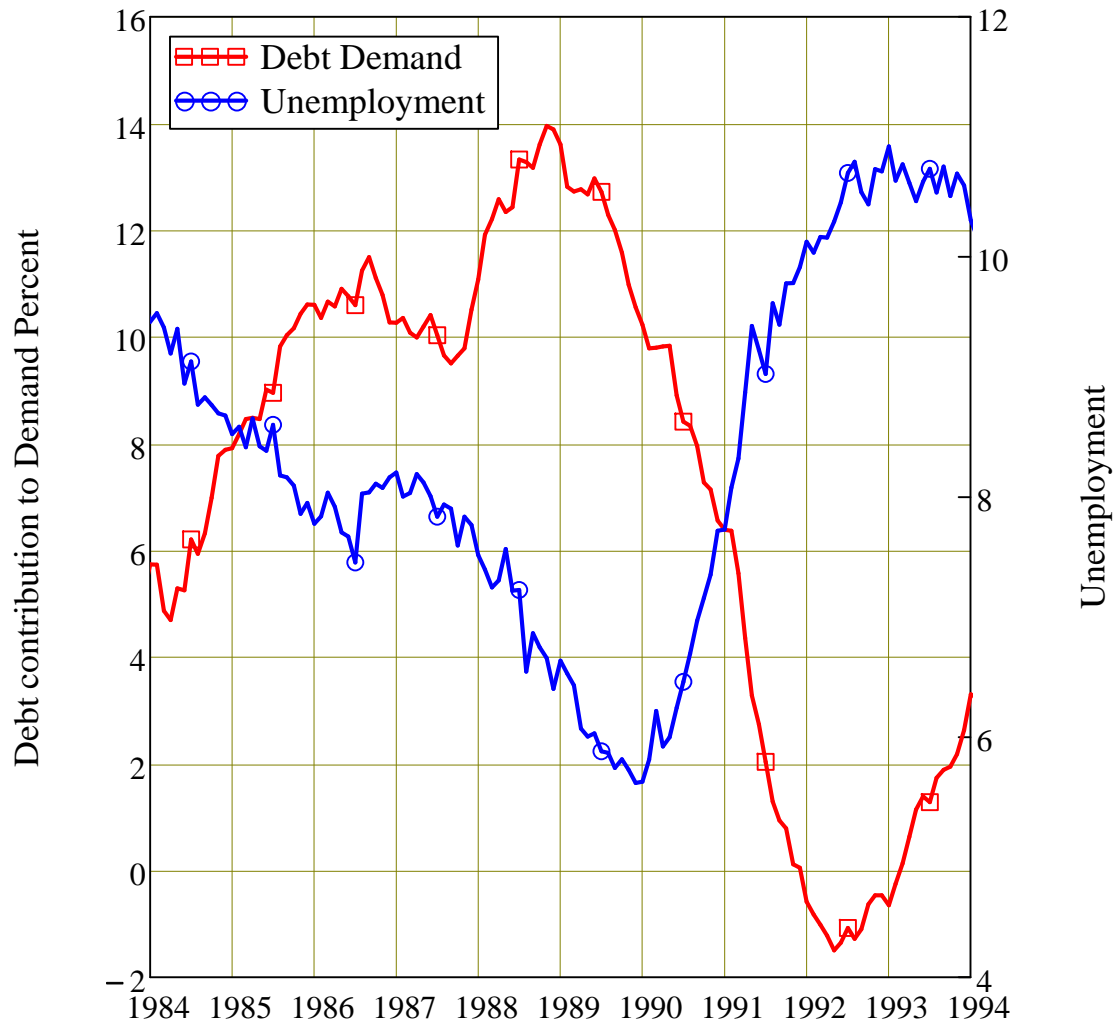
Then the rate of growth of debt decelerated--as the bubble in commercial property became obviously ridiculous, and the RBA's dramatic increase in rates finally bit--and the economy went into its deepest recession since WWII.

The Real Story: Debt



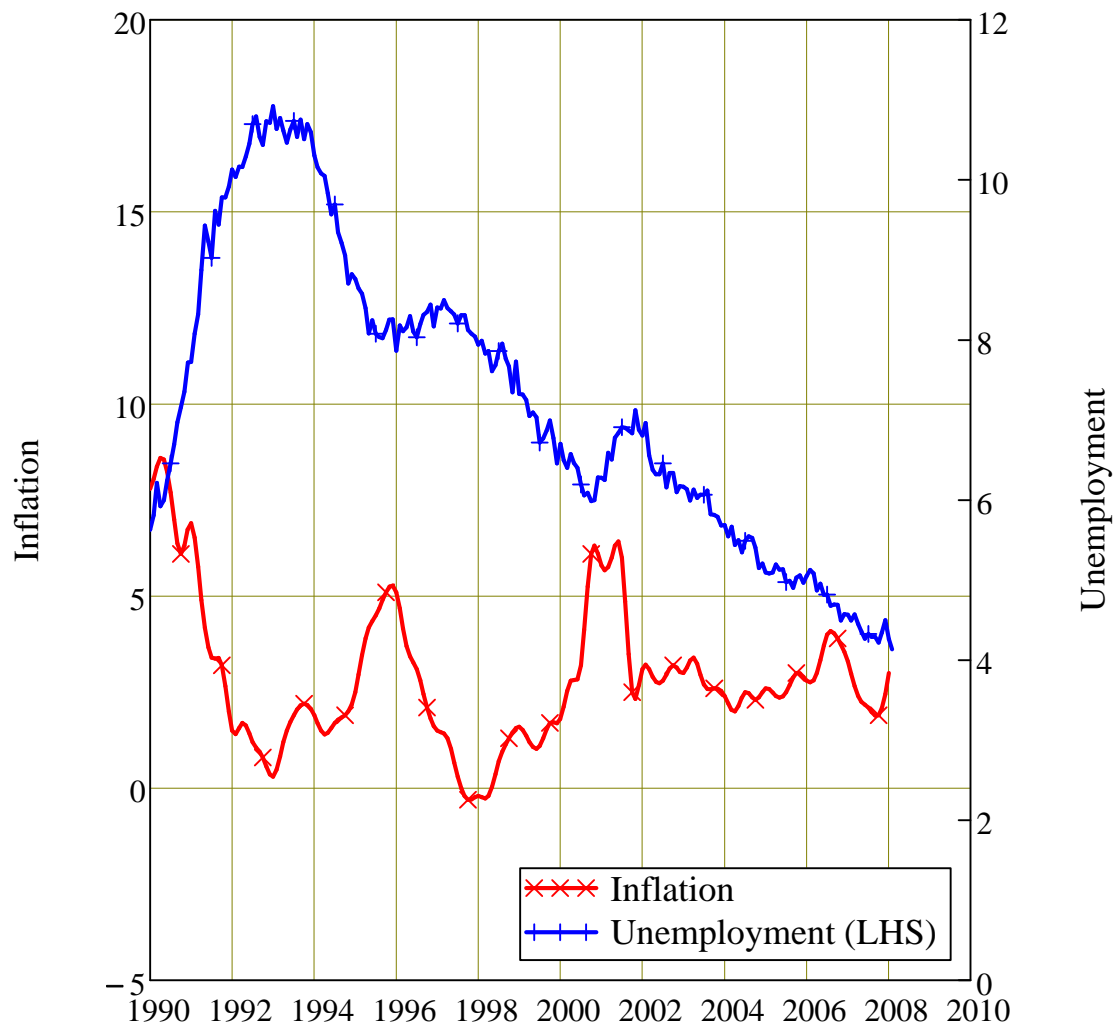
The 1990s downturn was more severe than the 1970s and mainly because debt was so much more important. Debt's contribution to demand in the 1980s bubble peaked at 14 percent--compared to 10 percent during the 1970s. Its minimum was actually negative (-1.5%) as corporate Australia drastically cut its debt levels--in part, deliberately and in part under duress.

Debt's contribution to Demand



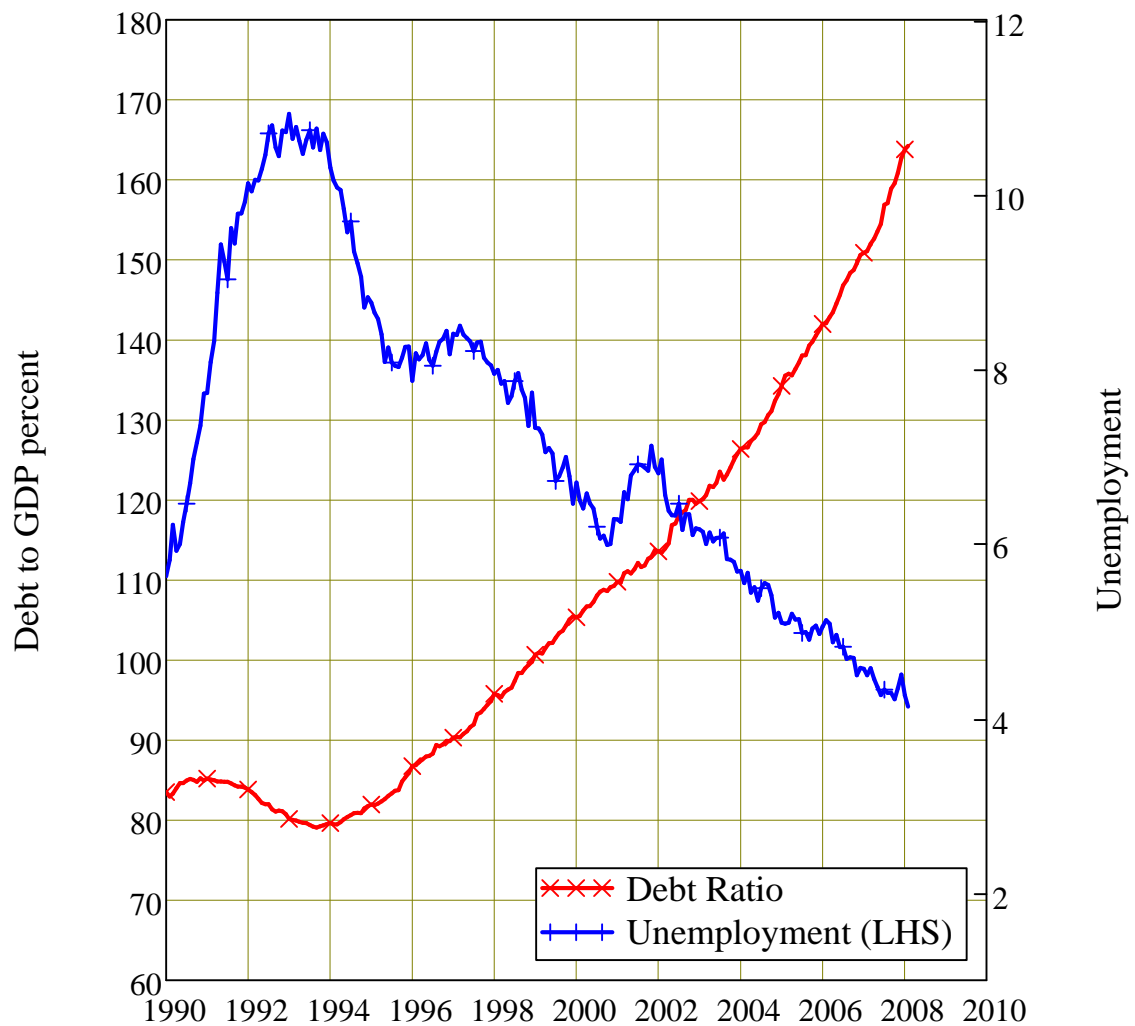
So what about today? We haven't had a bust--yet. And by conventional measures, we have had "the longest economic expansion in Australia's post-War history". Unemployment has fallen from 11 to 4 percent, while inflation has been quiescent, at normally under 3 percent.

The Howard & Costello Miracle?



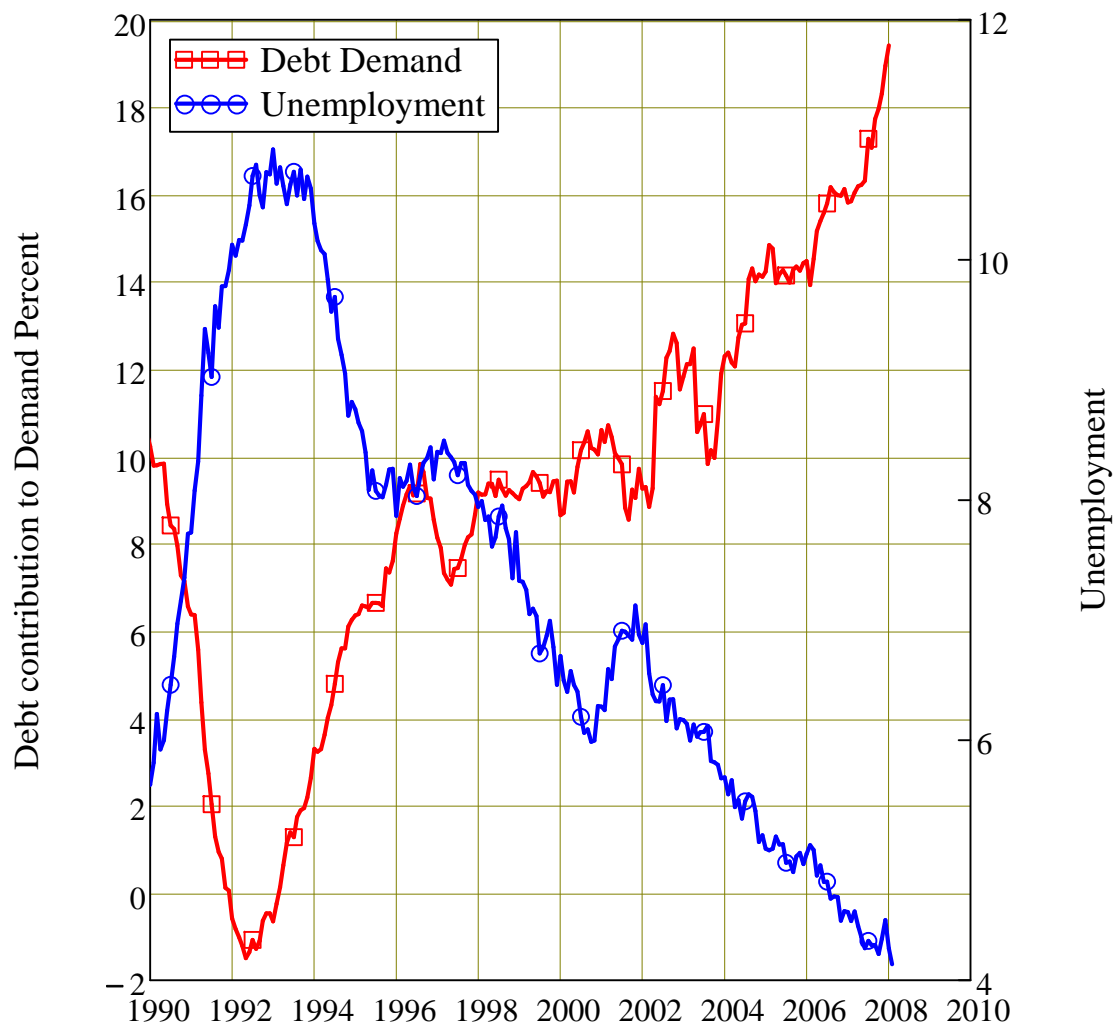
And behind this apparent success, once more, has lurked a debt bubble--the biggest in our history (and I'm talking since Captain Cook). The debt to GDP ratio bottomed out at 79 percent in mid-1993, and began a climb that is truly "the longest expansion in private debt in Australia's recorded history". When the "recovery" from the 1990s recession began, the debt to GDP ratio had fallen to 79 percent; it has since more than doubled to 164 percent. This, more so than China, has given us the apparent but illusory economic success of the last fifteen years.

The Real Story: Debt



Today, the annual increase in debt is responsible for almost 20 percent of aggregate spending in our economy. We have truly become addicted to debt.

Debt's contribution to Demand



The danger is that, if--when--the rise in debt comes to an end, so too will our apparent economic prosperity. As the 1990s collapse showed, debt can quickly go from making a positive contribution to demand to a decidedly negative one. Given that we have become so much more dependent on rising debt to fuel demand, the scale of the turnaround, when it comes, could dwarf 1990.

The secret to avoiding such problems, of course, is to develop "a `good financial society' in which the tendency by businesses and bankers to engage in speculative finance is constrained"--to quote Hyman Minsky from over 30 years ago. But we didn't do that, and at some stage, we must cope with the consequences.

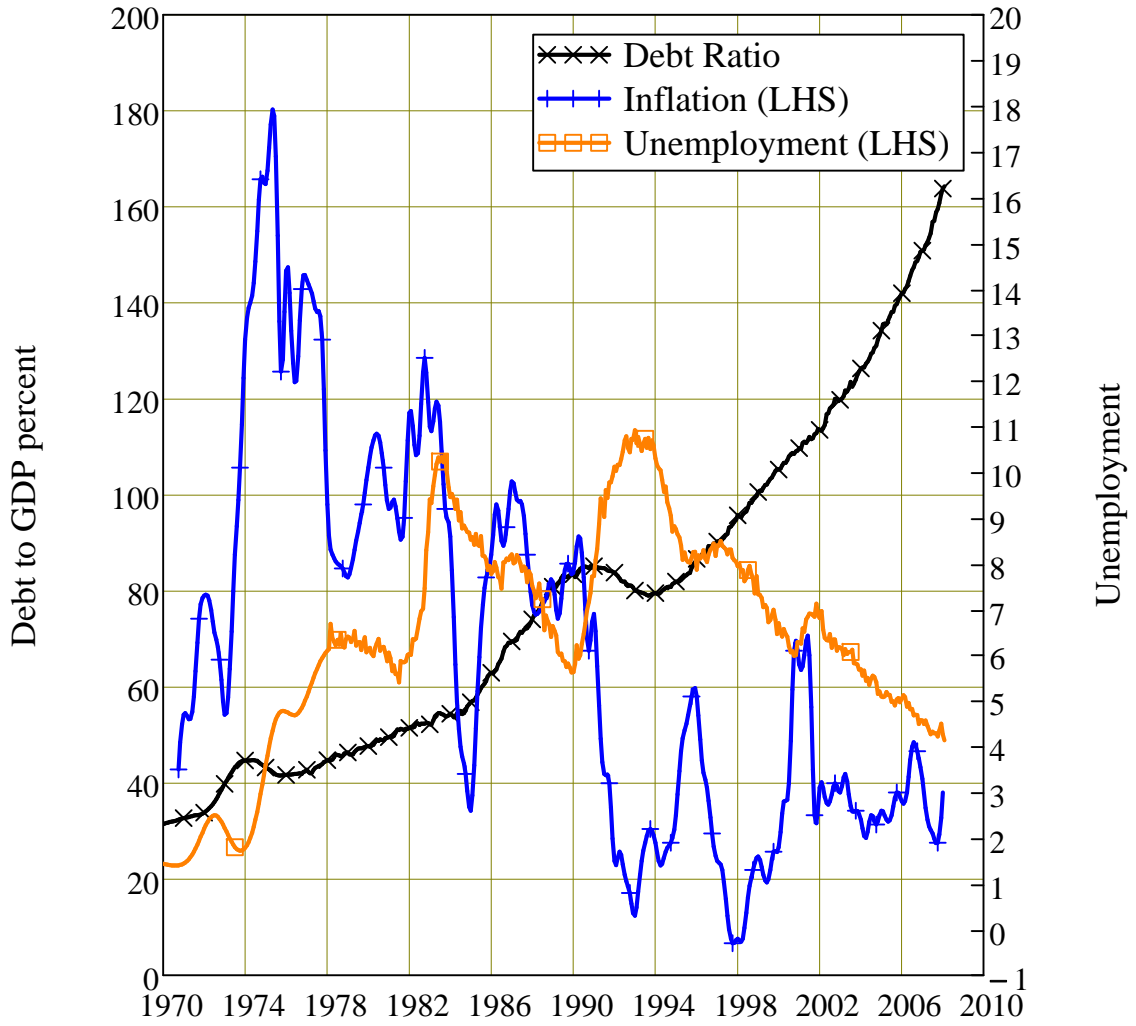
When that day of reckoning arrives, one thing that *won't* make things better is keeping the rate of inflation low. The high inflation of the 1970s is one factor that made that downturn less extreme than it could otherwise have been; and the lower inflation (and almost deflation) of the 1990s extended that recession.

Journalists with long memories may remember Warwick Fairfax lamenting that the low inflation of that time made his woes worse. If inflation had been higher, he could have put up the cover price of the Sydney Morning Herald and perhaps avoided bankrupting the family firm.

With inflation now even lower than it was when the '90s bubble burst, the real future danger is not rising prices, but the possibility of deflation.

END OF COMMENTARY

Debt, Inflation & Unemployment



Demand from Debt & Unemployment

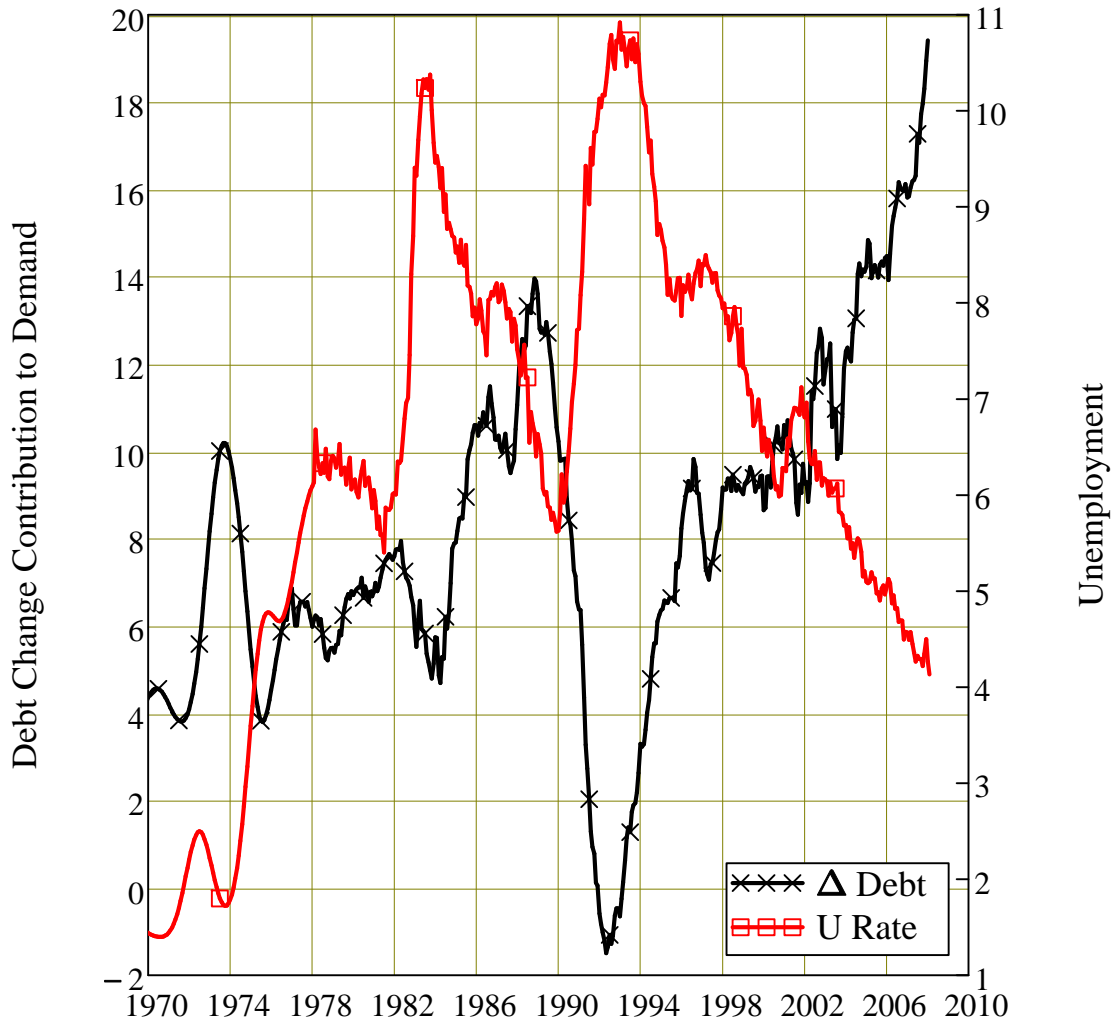


Chart One

Debt and Politics

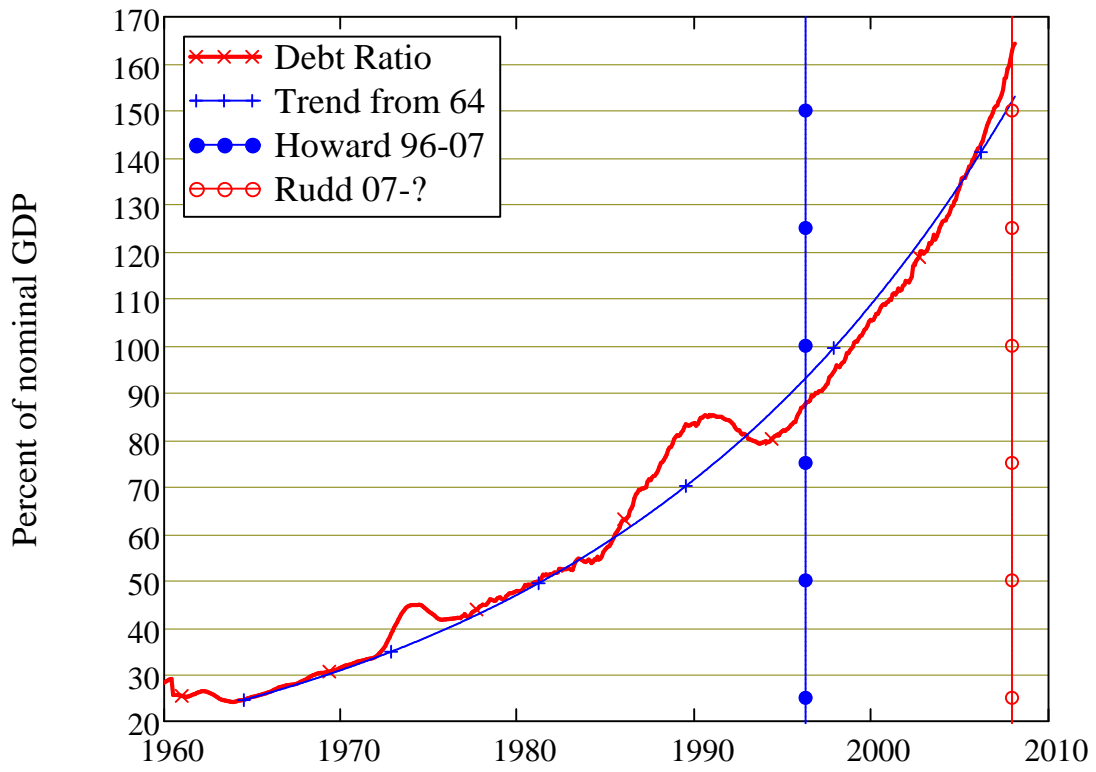


Chart Two

Long Term

Debt to GDP: The Long Term View

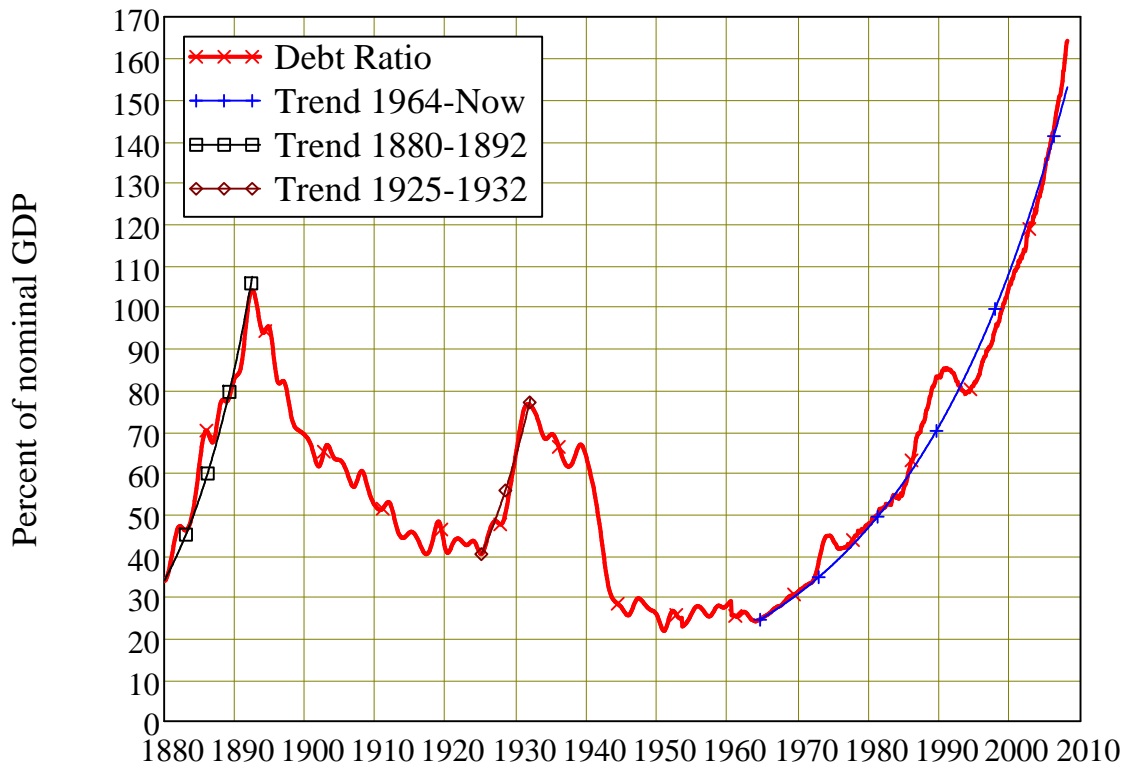


Table One: Aggregated Debt Summary

Table One

	0	1	2
0	"Summary"	"Total Private Debt"	"Nominal GDP"
1	"Date (levels)"	2008.08	2008
2	"Levels (\$m)"	1790305	1083793
3	"Change Month \$m"	15184	6341.42
4	"Change Month %"	0.86	0.59
5	"Change Year \$m"	264160	80347
6	"Change Year %"	17.31	8.01
7	"Since 1990"	8.7	5.45
8	"Since 1980"	11.99	7.91
9	"Since 1964"	13.47	9.38
10	"Date (% GDP)"	2008.08	"N/A"
11	"As % of GDP"	164.24	100
12	"Change Month"	0.28	"N/A"
13	"Change Year"	8.71	"N/A"
14	"Since 1990"	2.98	"N/A"
15	"Since 1980"	4.12	"N/A"
16	"Since 1964"	4.18	"N/A"

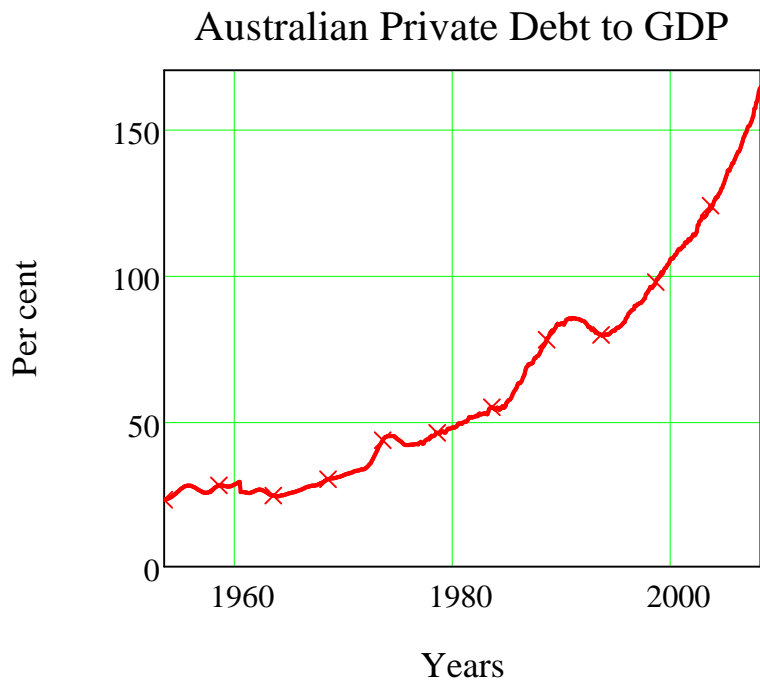
Table Two: Disaggregated Debt Summary

Table Two

	0	1	2	3
0	"Detail"	"Business"	"Mortgage"	"Personal"
1	"Levels (\$m)"	713215	924113	152976
2	"Change Mth \$m"	10517	6101	-1434
3	"Change Mth %"	1.5	0.66	-0.93
4	"Change Yr \$m"	148236	98166	17758
5	"Change Yr %"	26.24	11.89	13.13
$D_2 =$ 6	"Since 1990"	5.13	14.67	5.6
7	"Since 1980"	10.64	14.02	10.45
8	"Since 1976"	11.17	14.29	11.22
9	"As % of GDP"	65.43	84.78	14.03
10	"Change month"	0.91	0.09	-1.5
11	"Change year"	16.98	3.68	4.83
12	"Since 1990"	-0.68	9.16	-0.3
13	"Since 1980"	3.01	6.04	2.63
14	"Since 1976"	3.09	5.82	3

Debt to Income Ratios

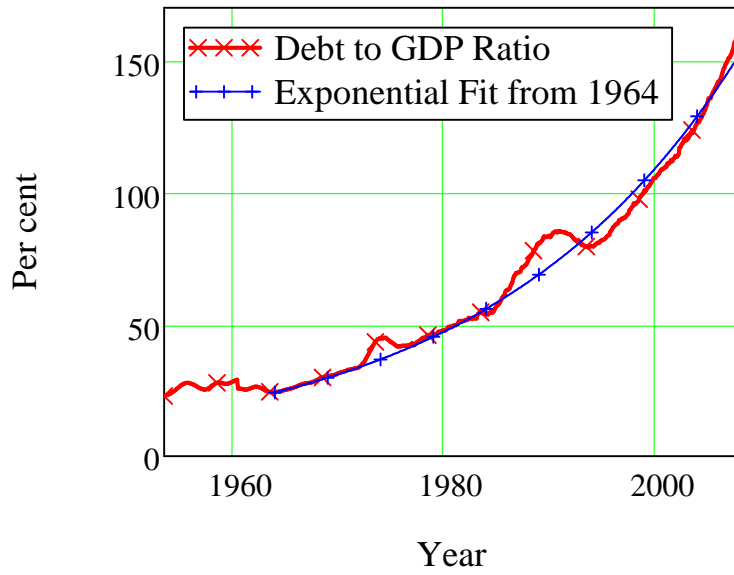
▣ Debt to GDP (D02 & G12)

Figure 1

▣ Debt to GDP Regression

Figure 2

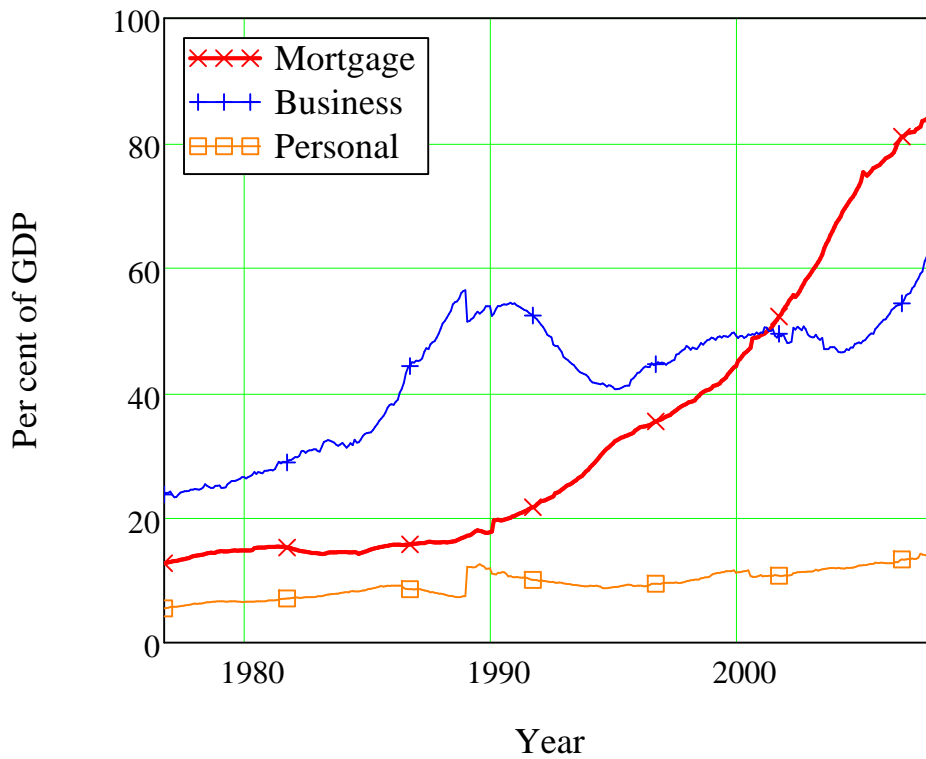
Australian Private Debt to GDP



▢ Debt Components to GDP

Figure 3

Components of Australian Debt



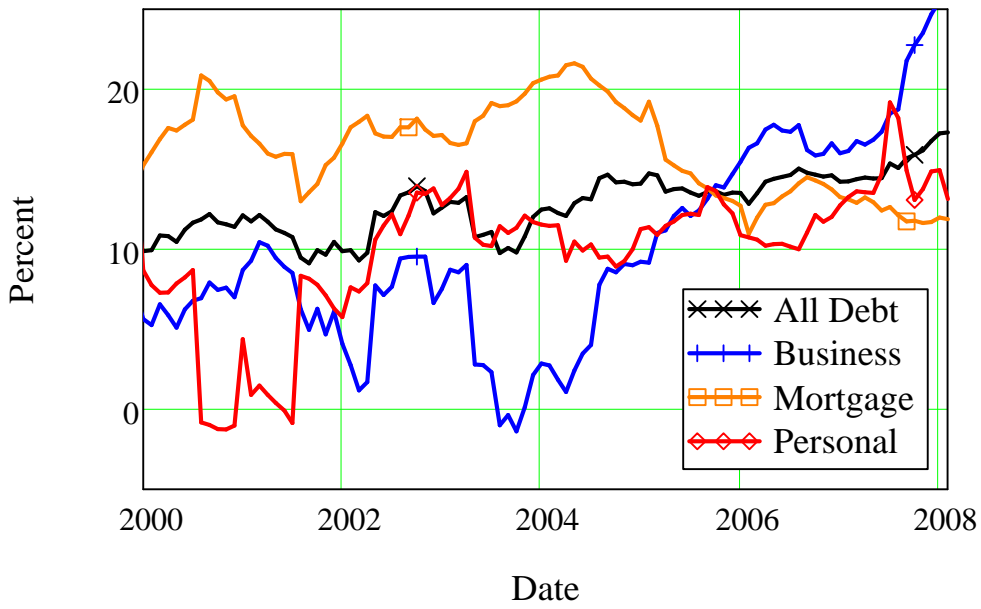
▢ Monthly Growth Rates

Debt Monthly Growth Rates



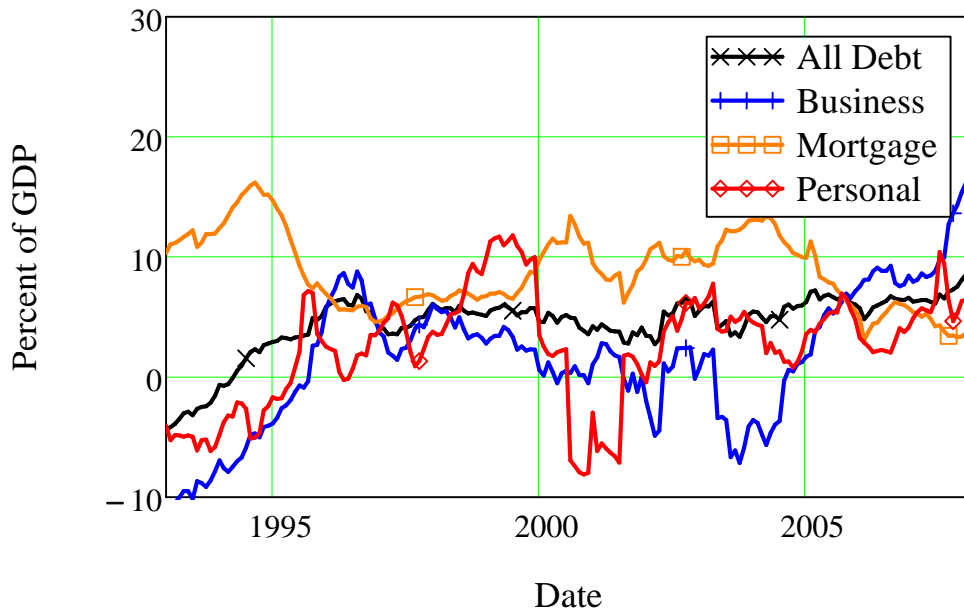
▶ Yearly Growth Rates

Debt Yearly Growth Rates



▶ Ratios Yearly Growth Rates

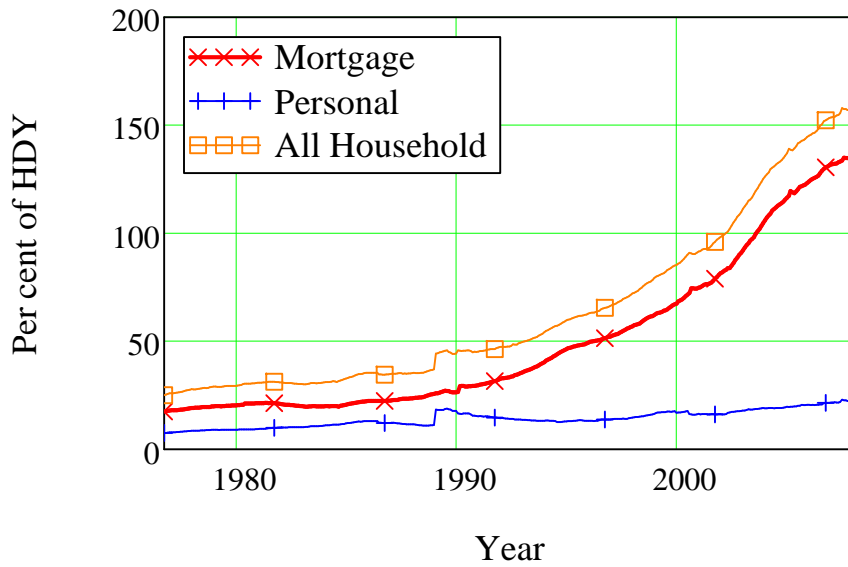
Debt Ratios Yearly Growth Rates



▢ Debt to Household Disposable Income

Figure 4

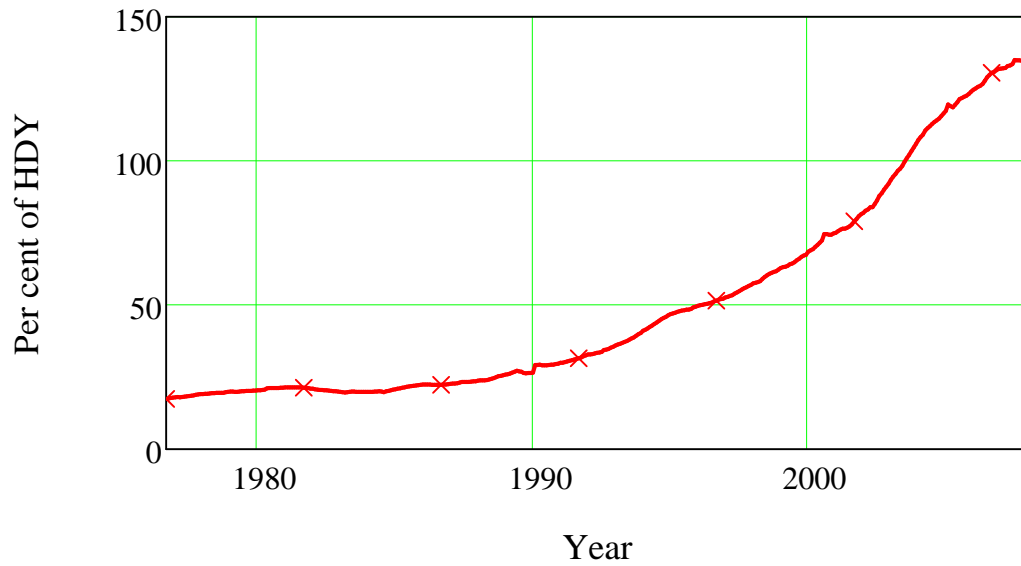
Household Debt to Disposable Income



▢ Mortgage Debt to Household Disposable Income

Figure 5

Mortgage Debt to Household Disposable Income

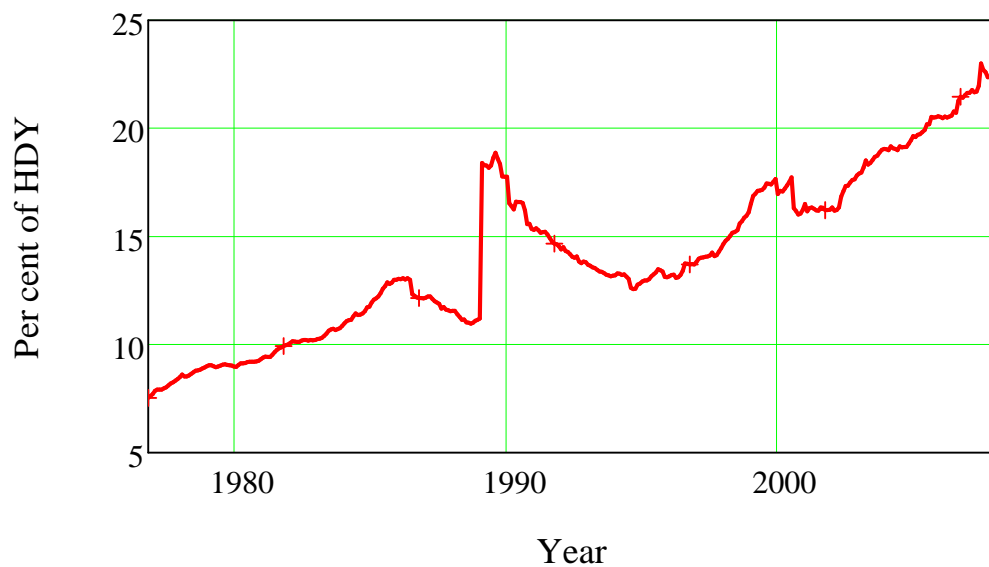


▢ Debt to Household Disposable Income

(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

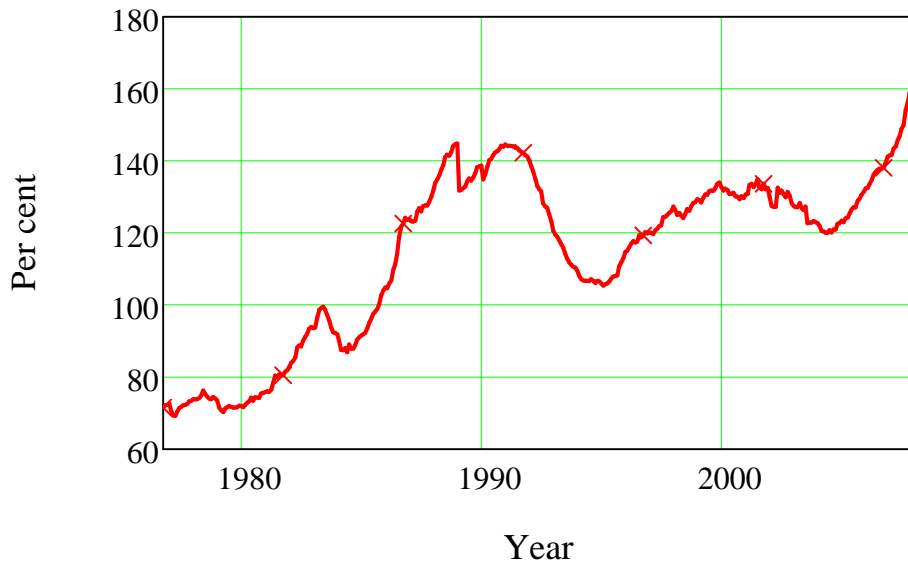
Personal Debt to Household Disposable Income



▢ Business Debt to GOS

Figure 7

Business Debt to Gross Operating Surplus

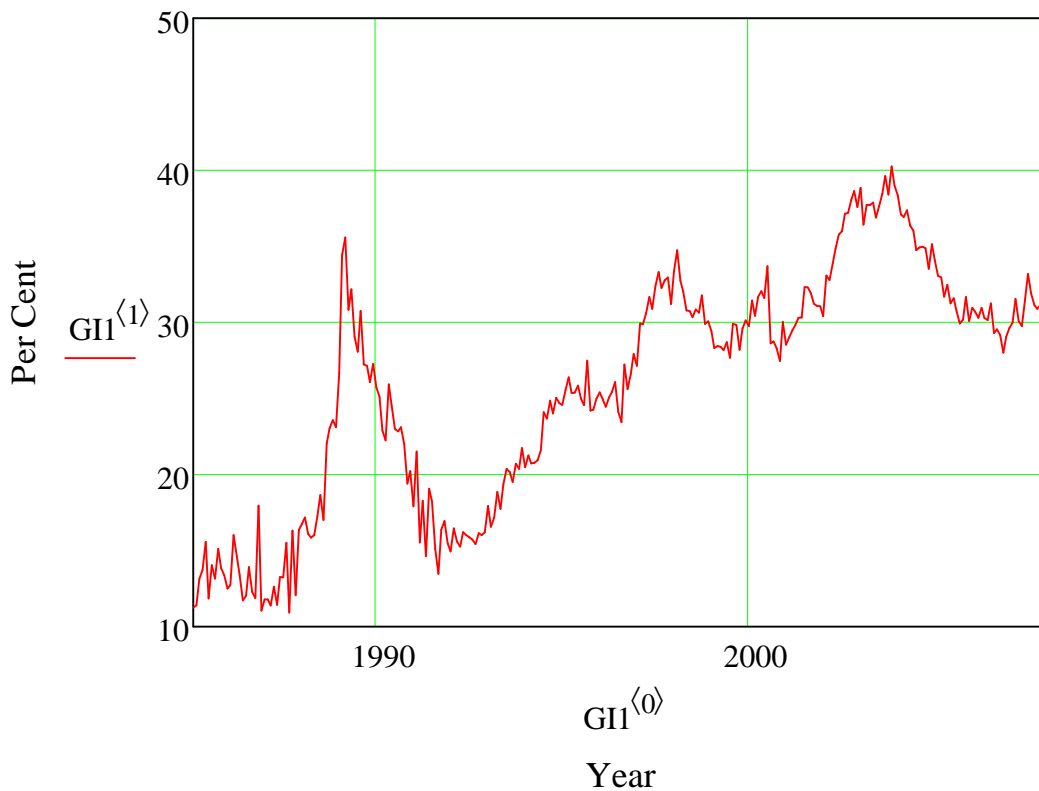


Housing Finance Analysis

▢ Investment Percent Total Housing Lending

Figure 8

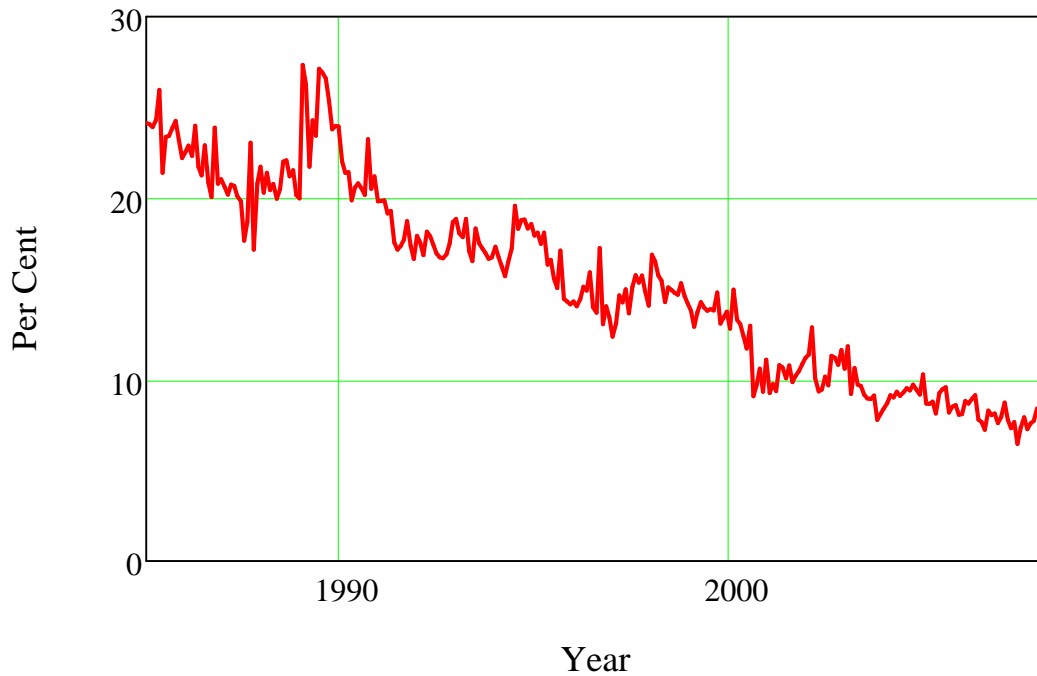
"Investor" Percentage of Total Housing Lending



▢ Construction Percent Total Housing Lending

Figure 9

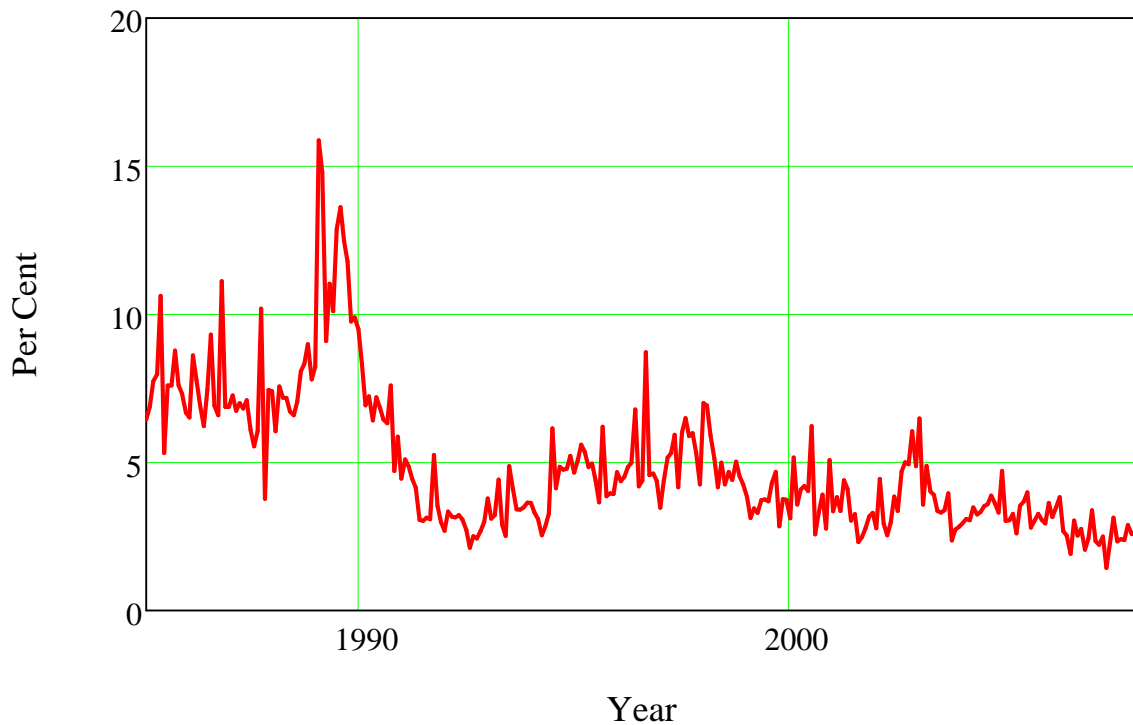
Construction Percentage of Total Housing Lending



▢ Investment Construction Percent Total Housing Lending

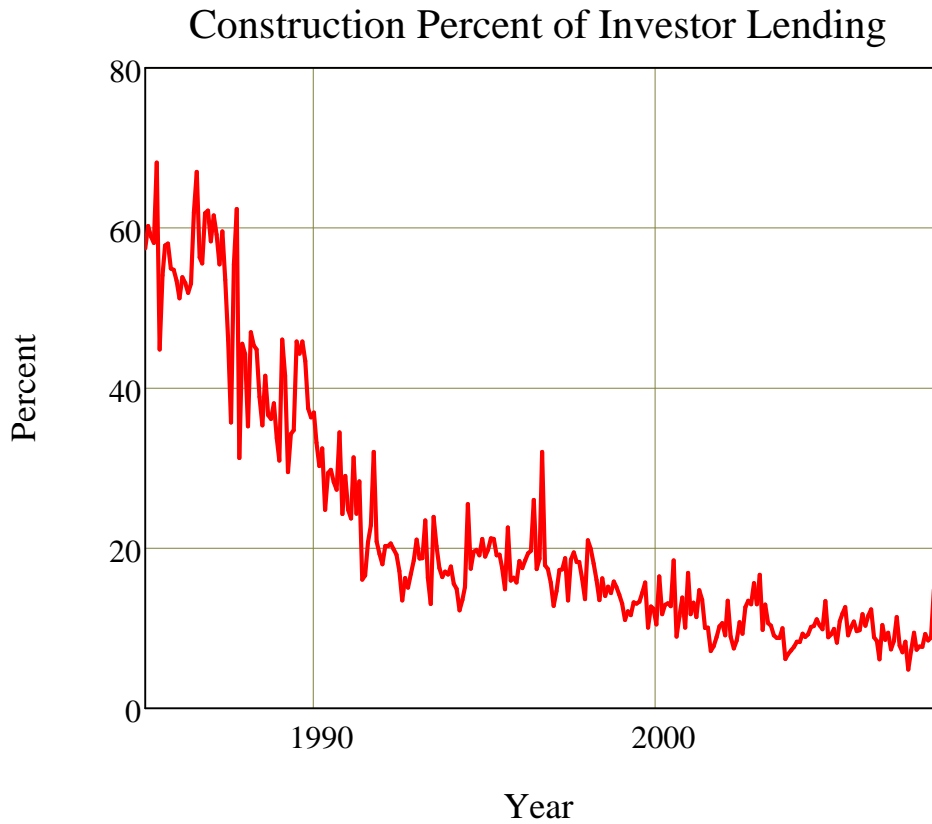
Figure 10

Investor Construction Percent of Total Housing Lending



▢ Construction Percent of Investor Lending

Figure 11



Personal Finance Analysis

Figure 12

▢ Credit Card Data

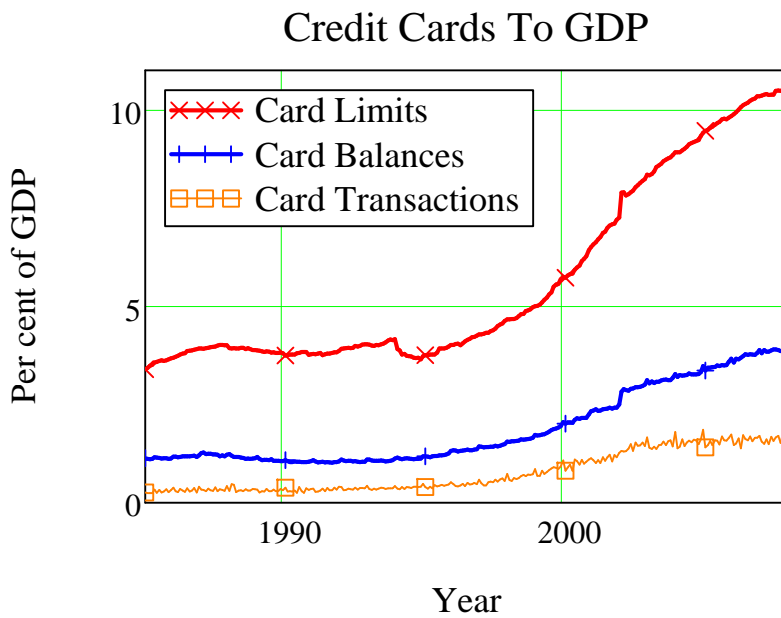


Figure 13

▣ Credit Card Data

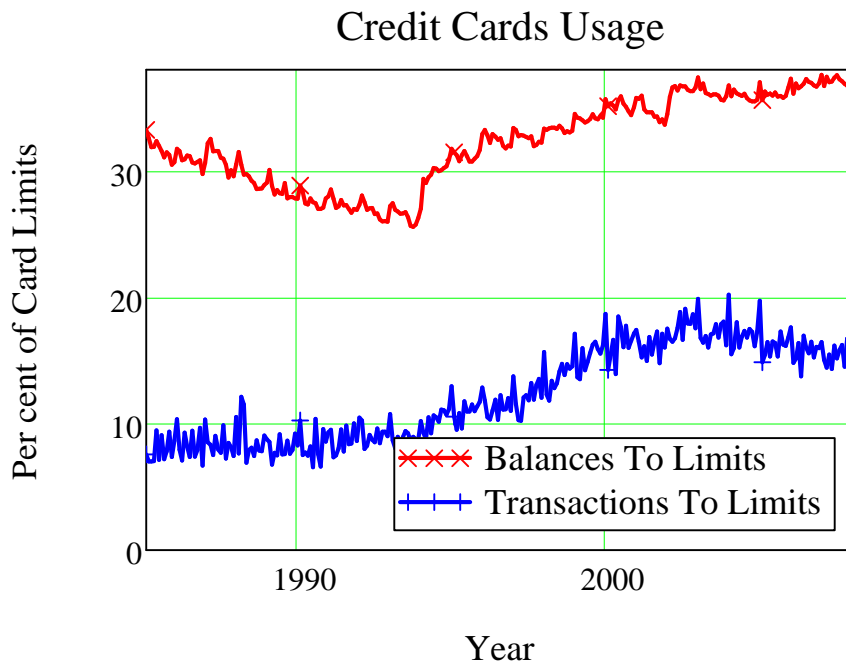
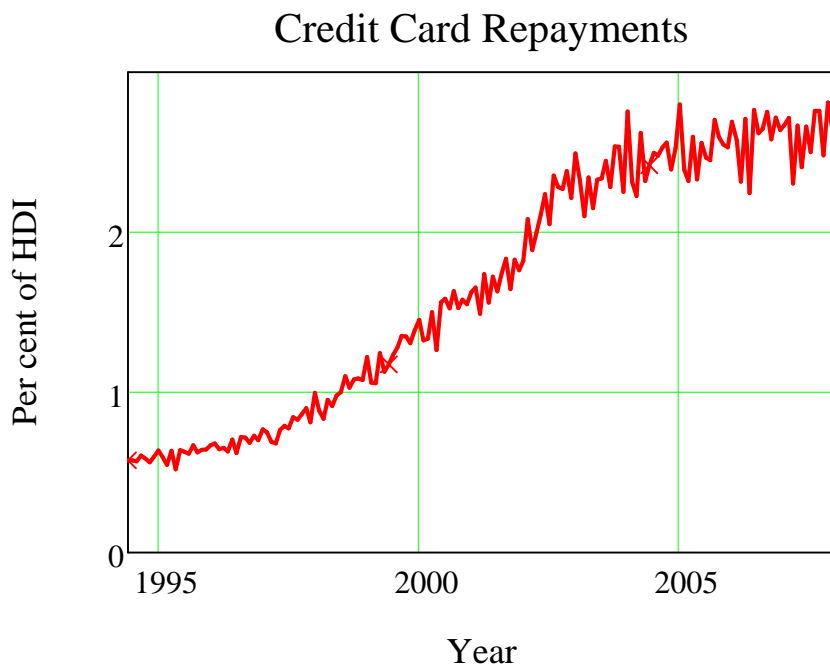


Figure 14

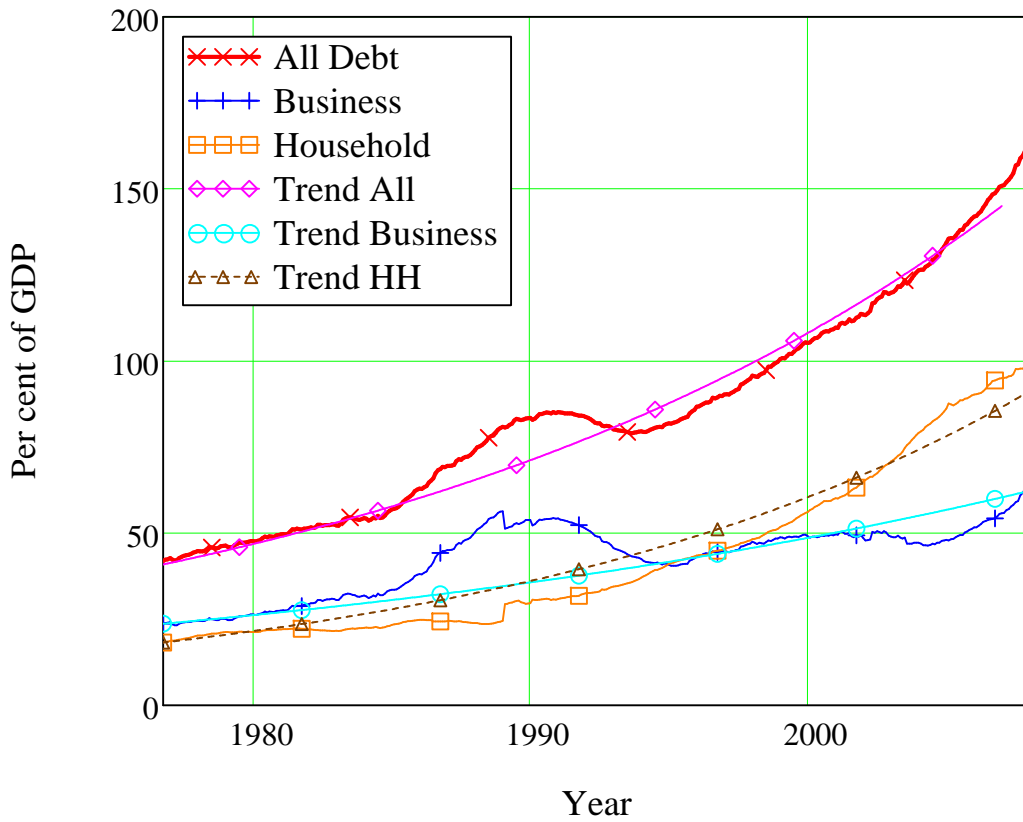
▣ Credit Card Repayments



▣ Debt components to Income

Figure 14

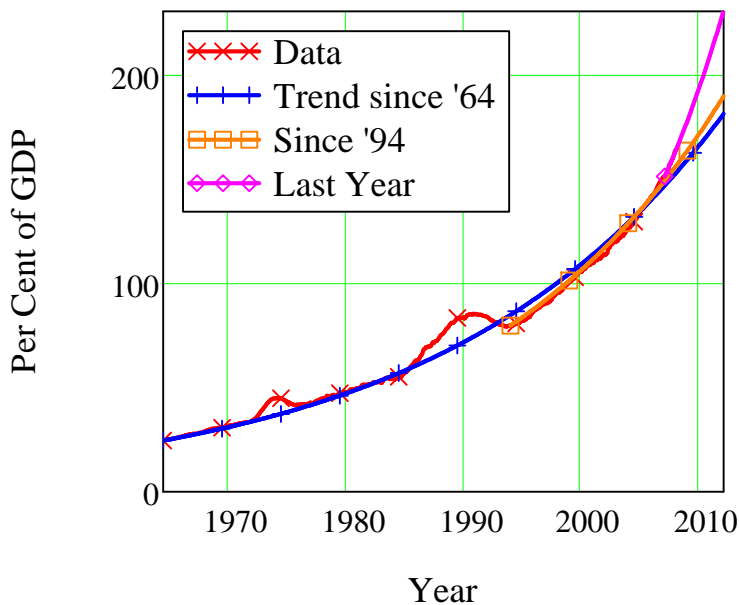
Trends in Private Debt



▢ Debt to GDP Trends

Figure 15

Debt to GDP Ratio and Trends



▢ 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	5
0 "Debt ratios"	"All"	"All"	"All"	"Business"	"Household"	"Mortgage"
1 "Start Date"	"mid-1964"	1977	1977	1977	1977	1977
2 Growth rate"	4.18	4.06	3.1	5.09	5.82	
3 "Correlation"	99.12	98.44	73.34	98.13	98.3	
4						

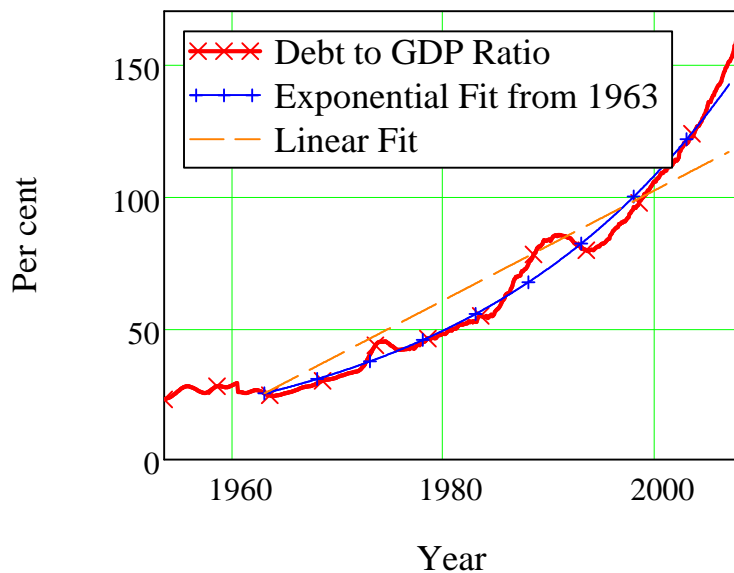
Table Four: Exponential Growth Rates & Correlations since 1990

	0	1	2	3	4
0 "Debt ratios"	"All"	"Business"	"Household"	"Mortgage"	
1 "Start Date"	1990	1990	1990	1990	
2 "Growth rate"	2.79	-0.98	6.81	9.31	
3 "Correlation"	96.46	-16.9	99.68	99.77	

▢ Debt to GDP Linear vs Exponential Regressions

Figure 16

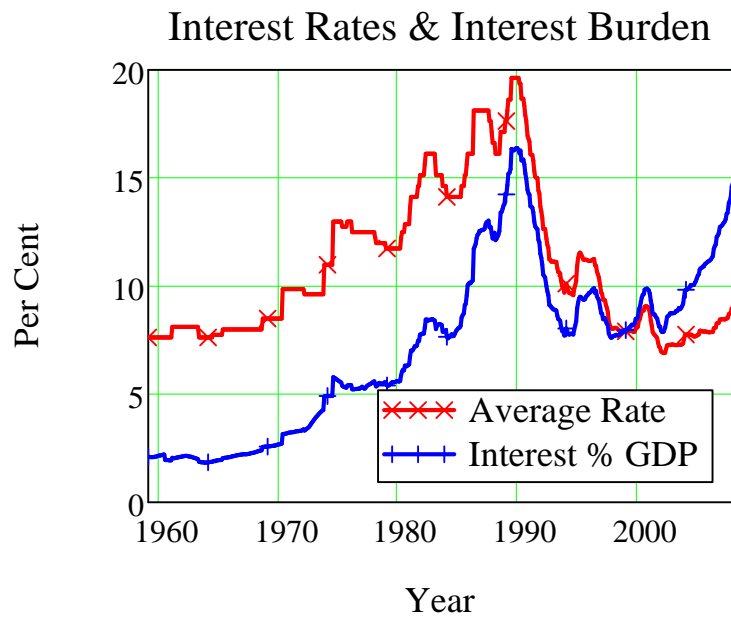
Australian Private Debt to GDP



Debt Servicing Burden

▶ Interest Rates & Payments

Figure 17

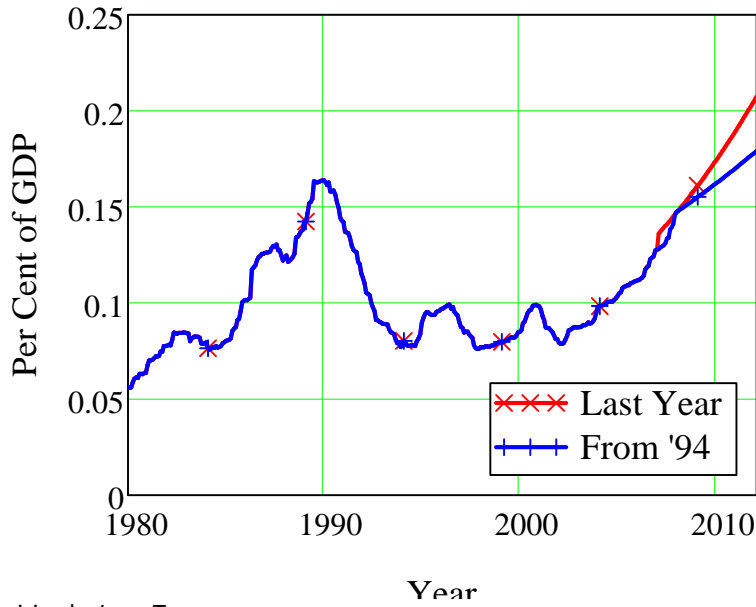


▶ Interest Payment Trends

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

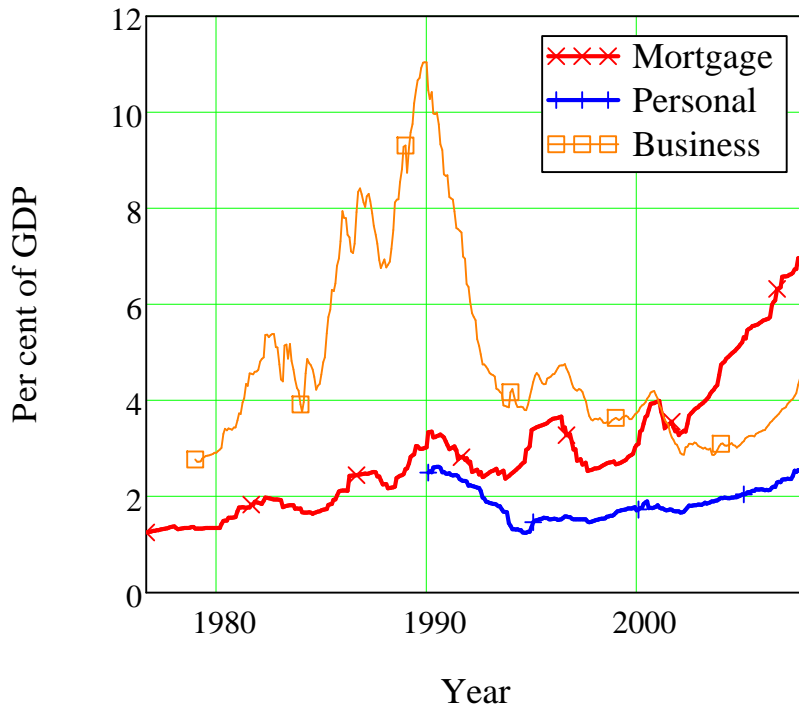
Interest Repayment Burden Trends



▶ Debt Servicing by Loan Type

Figure 19

Debt Servicing Burden



▶ Household Debt Servicing

Figure 20

Household Debt Servicing Burden

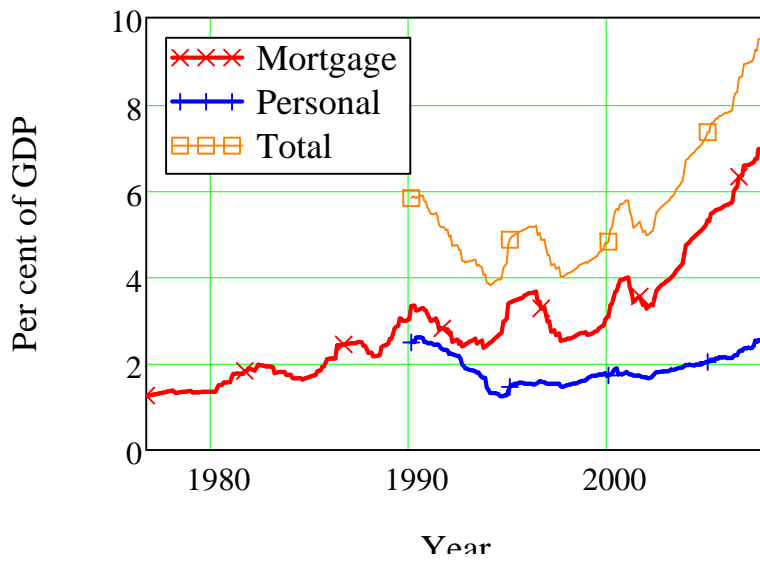
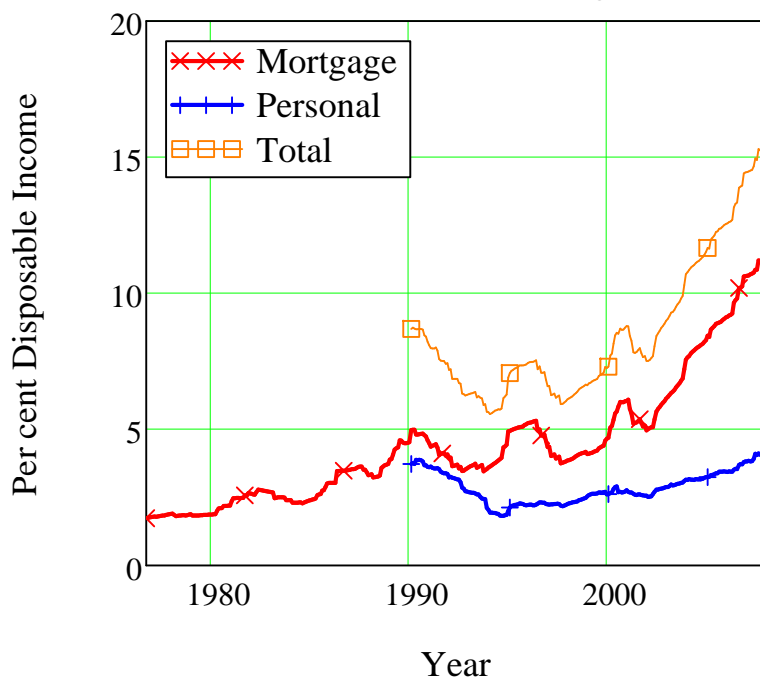


Figure 21

Household Debt Servicing Burden



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

Interest Payment Burden

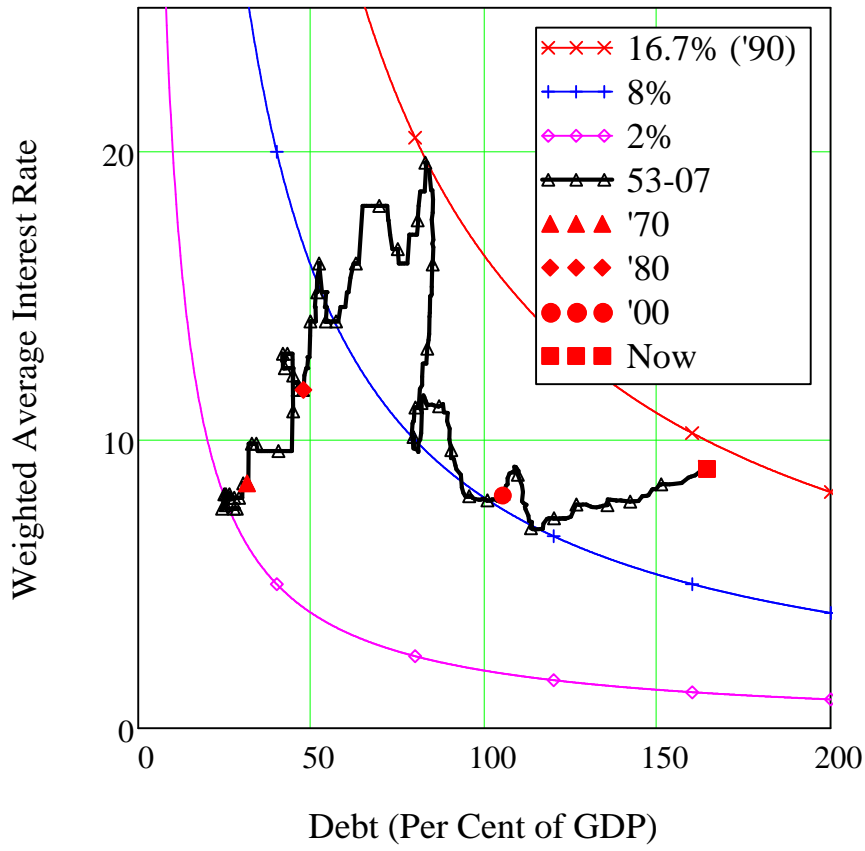


Figure 23

Inflation-Adjusted Interest Payment Burden

