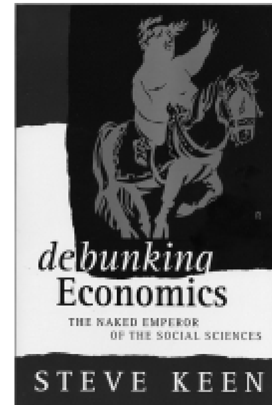
Steve Keen's Debtwatch February 2007



Speculation that the RBA will increase interest rates this month has abated, after an unexpected fall in inflation. Though the annual headline rate was above the RBA's "comfort zone" at 3.3%, the quarter actually registered a drop in the CPI of 0.1%.

Since a rate rise is now unlikely, this month's report focuses on how little flexibility the RBA actually has on interest rates. The RBA can only manage two more movements up before the debt burden will be as great as it was at the start of the 1990s recession. In the other direction, even a Cash Rate of zero wouldn't reduce the debt burden to 1970 levels.

"Chart of the month": the interest payment burden as a function of interest rates and debt levels

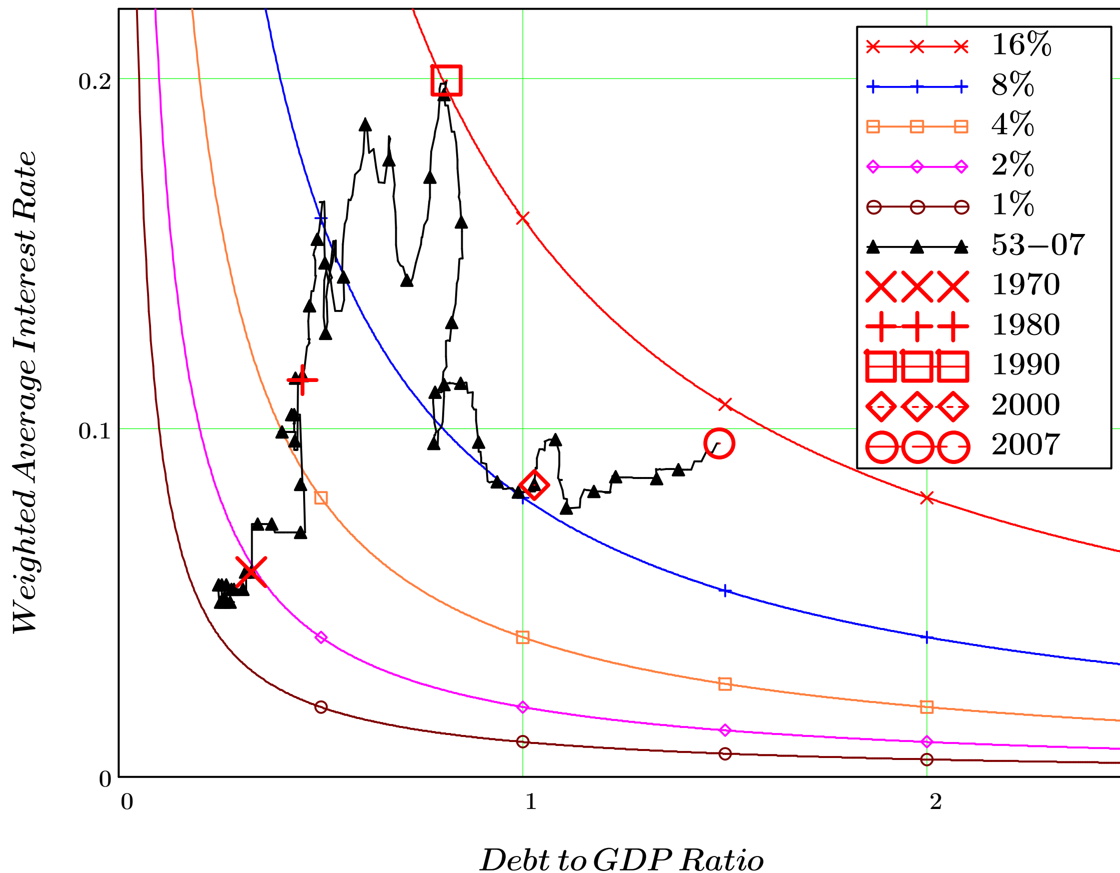
This chart tracks Australia's shift from a low debt to a high debt country over the course of the last half century. The "isobars" represent the proportions of GDP needed to pay the interest on private debt, given different combinations of average interest rates and debt to GDP ratios. The 1953-2007 line shows the actual course of the private debt burden in Australia, with each symbol representing one year.

During the 1950s and 1960s, interest payments accounted for less than 2% of GDP (or "2 cents in the GDP dollar"). Then, early in 1970, rising interest rates and rising debt levels took us across the 2% line.

A rapid increase in debt--from 32% to 45% of GDP in just 4 years--took us from under the 2% isobar to almost 4%. Then escalating interest rates--associated with increasing inflation--pushed us from the 4% to the 8% level over the next 8 years, with only a comparatively modest increase in the debt ratio.

Then all hell broke loose during the 1980s. Debt escalated all the way, while interest rates soared, sank, and soared again as regulators reacted to the 1983-87 stockmarket boom, the 1987 stock market crash, and the 1987-89 property boom. This was also the period of the now-discredited "monetarist" attempt to control the economy by targetting the rate of growth of the money supply, which explains some of the volatility in interest rates. The decade's close saw the highest official and market interest rates in the last 50 years.

In the aftermath of the crash, interest rates plunged as regulators found, in retrospect, that their tighteting had been too severe. Eventually, even debt levels fell relative to GDP. This was only the second time this had happened in the post-WWII period, and it was also the second time this phenomenon coincided with a severe recession.



Debt levels began to rise again when the economic recovery began in 1994, and rising debt has pushed us ever closer to the interest-payment level that caused the last crisis--even though rates are less than half their 1990 peak. Only the China boom is making it possible to service this level of debt--which is cold comfort to many property owners in the eastern states.

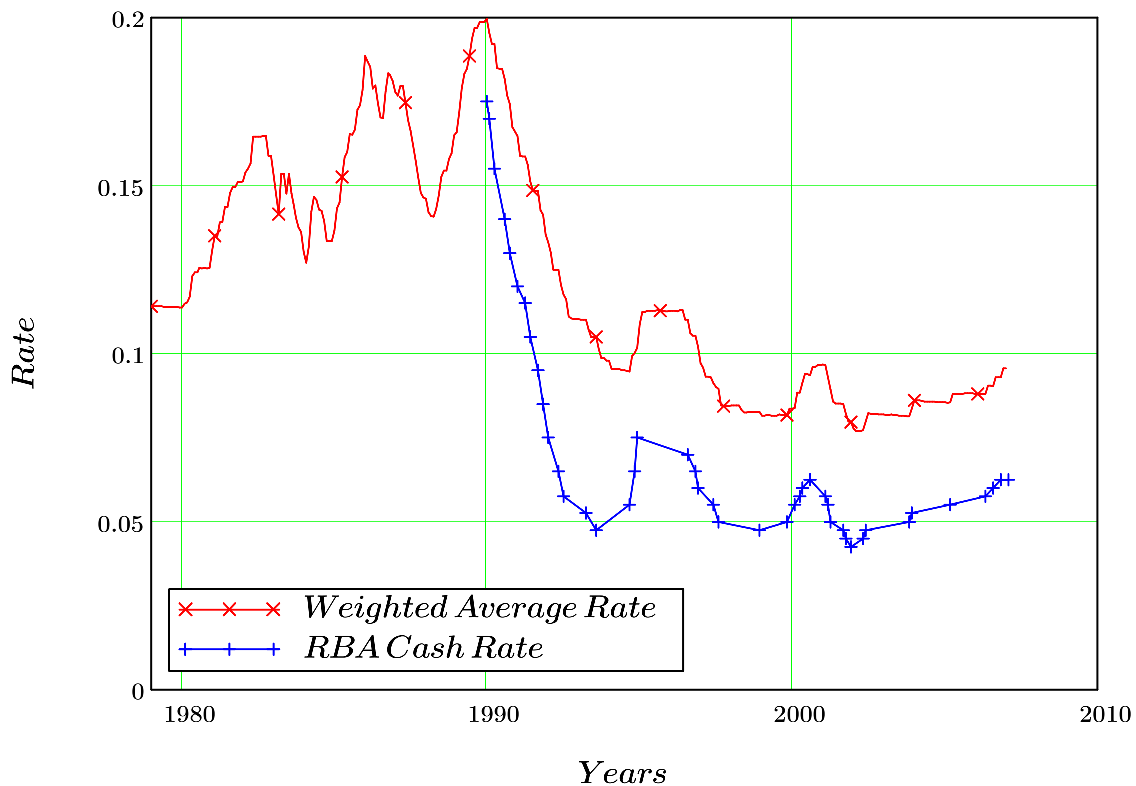
If debt levels keep increasing at the current rate, we'll hit the 16% pain level in mid 2008, even without any further increases in interest rates.

Increased debt levels also constrain the RBA's capacity to regulate economic activity using official interest rates. Given the current debt to GDP ratio of 148.6%, a rise in rates of a mere half of one per cent would bring us back to the same 16% pain level that ushered in 1990s recession--which is an added reason why the next move in official interest rates is more likely to be down than up.

Equally, it can't do all that much to stimulate the economy by reducing rates, should a recession eventuate. Weighted average interest rates are generally 3.3% above the RBA Cash Rate. If the Bank wanted to stimulate the economy as much as it did to get it out of "the recession we had to have", it would need to reduce the debt burden to 8% of GDP. This would require a fall in average interest rates to 5.4%, which would require an RBA Cash Rate of around 2%--compared to the 4.75% level that did the same trick in 1994.

A return to the 4% debt burden level that applied in 1973 would require average interest rates of just 2.7%--and an impossible negative RBA Cash Rate. The halcyon days of the early 1970s are now permanently out of reach--at least without a substantial fall in the debt to GDP ratio.

The RBA simply doesn't have much room to manoeuvre: it is now caught in a private debt straightjacket. So too, it appears, are Australian households.

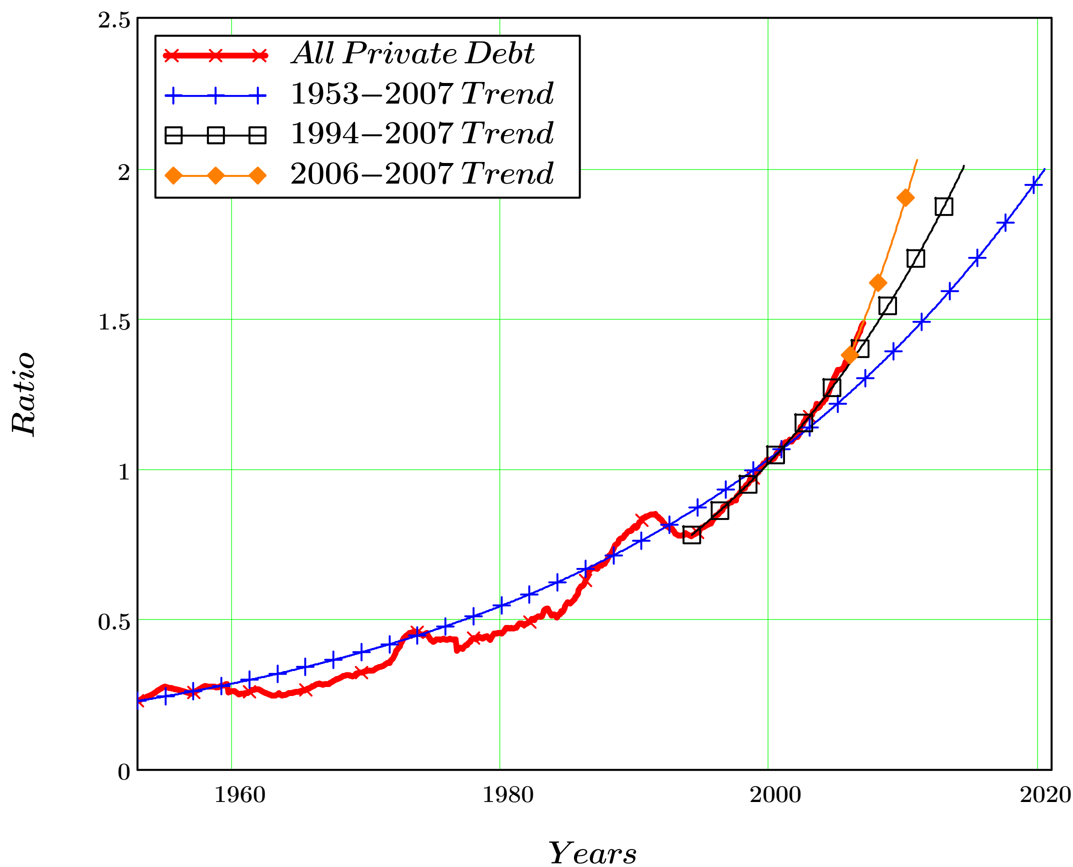


2020 Vision: the approaching debt crisis

The ratio of private debt to GDP rose to 148.6% in December 2006--a 0.6% increase for the month. Over the calendar year, the ratio rose almost 11 per cent. It is now 75 per cent higher than the previous Debt/GDP peak of 85% in March 1991, during "the recession we had to have".

The rate of growth has also accelerated. From 1953 till 2007, the annual rate of growth was 3.2%; since 1994, the growth rate has been 4.6% p.a.; over calendar year 2006, it was 7.7%.

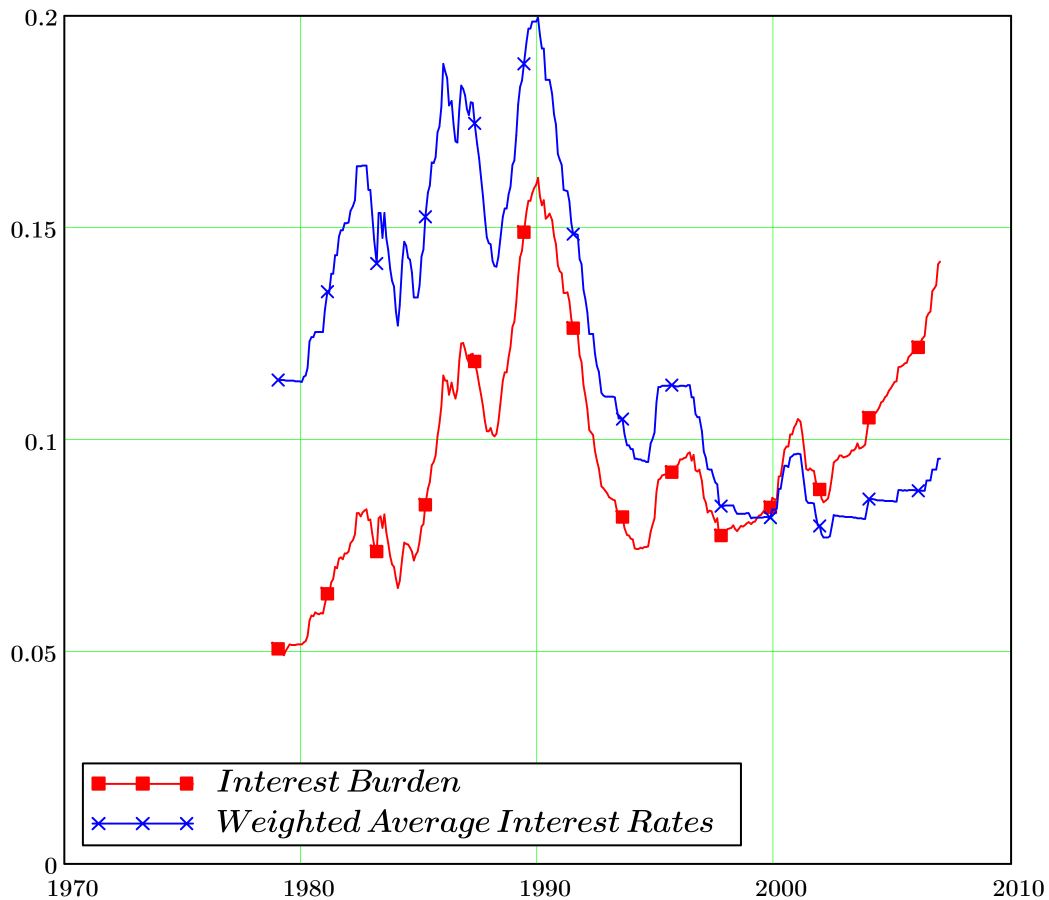
Even the long-term trend itself is unsustainable--debt ***cannot*** keep growing faster than income forever. But the current rate of increase is even more worrying. If the rate of growth remained at the 1953-2007 average, debt would take until 2020 to hit twice GDP. At the 1994-2007 rate, it would be double GDP by 2015. At the 2006-2007 rate, it will hit twice GDP by mid-2010--during the term of the next Federal Government.



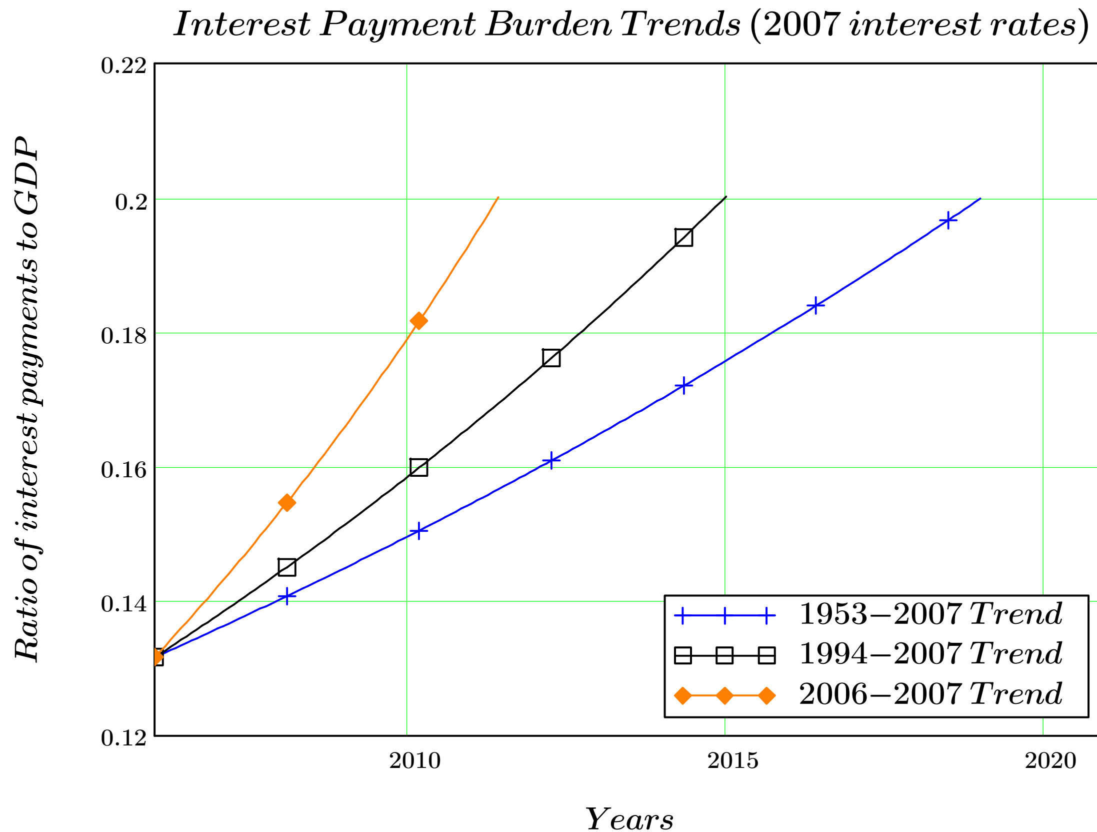
This accelerating level of debt is rapidly pushing us towards a debt crisis like the one that ushered in the 1990 recession. Then, excessive corporate borrowing and high interest rates combined to bring about a recession. The weighted average interest rate is now much lower than back in 1990: 9.56 per cent now, versus the 1990 peak of 19.95%. But the burden of debt repayment on the economy is almost as high now as then, because the level of debt is so much higher.

In 1990, 16.2 cents in every GDP dollar went to interest payments--and anyone who was an adult then doesn't need reminding that these crippling interest payments were what finally stopped the 1980s speculative bubble in its tracks. The interest burden dropped rapidly to a low of 7.4 cents in the dollar as rates were cut to an average of 9.5% in mid 1994. But from then on it has risen, despite further falls in interest rates. Even when the weighted average rate hit its lowest level in over 25 years--7.7% in early 2002--the interest payment burden was 8.6 cents in the dollar.

Since 2002, increases in official interest rates have compounded with rising debt levels to push the interest repayment burden back to 14.2 cents--just 2 cents below the level that triggered the 1990s recession.



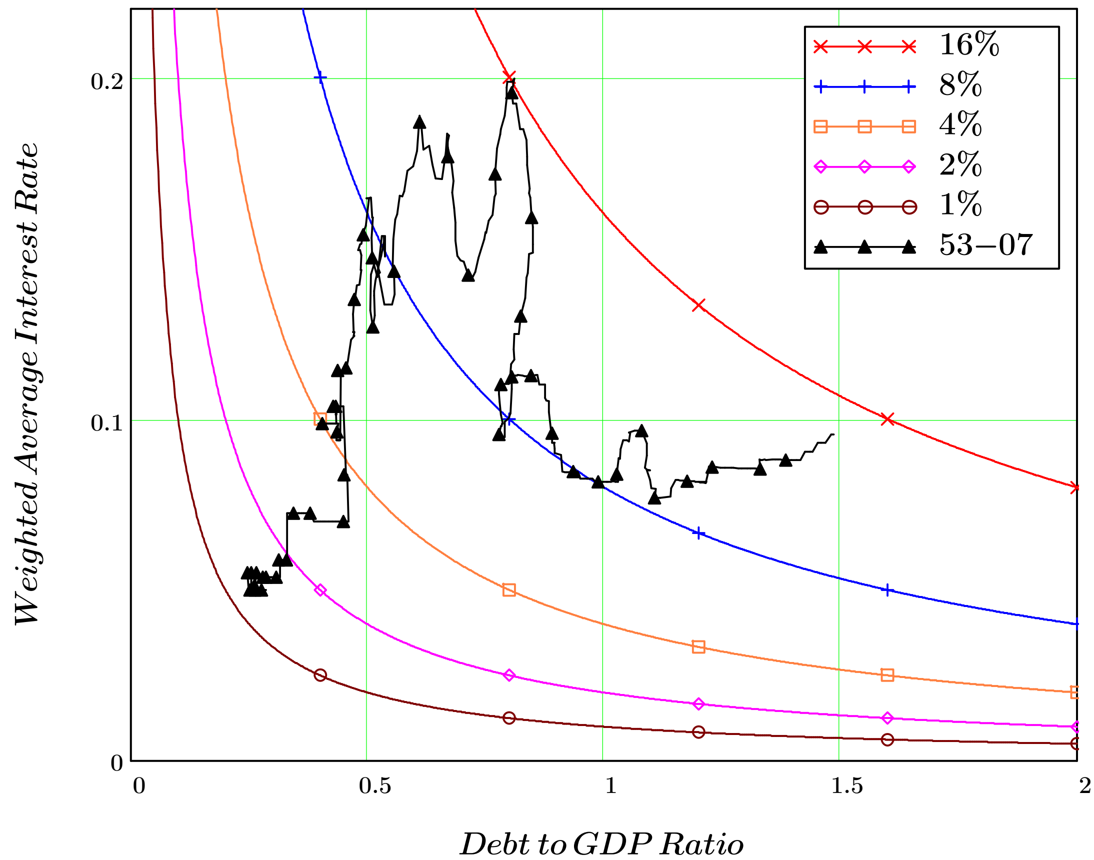
If the explosive growth in debt continues, it won't be long till we're back to the 1990 level again. At the 2006-2007 rate of growth, we will hit 1990 debt repayment levels in mid-2008--less than a year into the term of the next Federal Government. Even if the lower 1953-2007 growth rate continues, we will reach that milestone--or rather, millstone--by mid 2012.



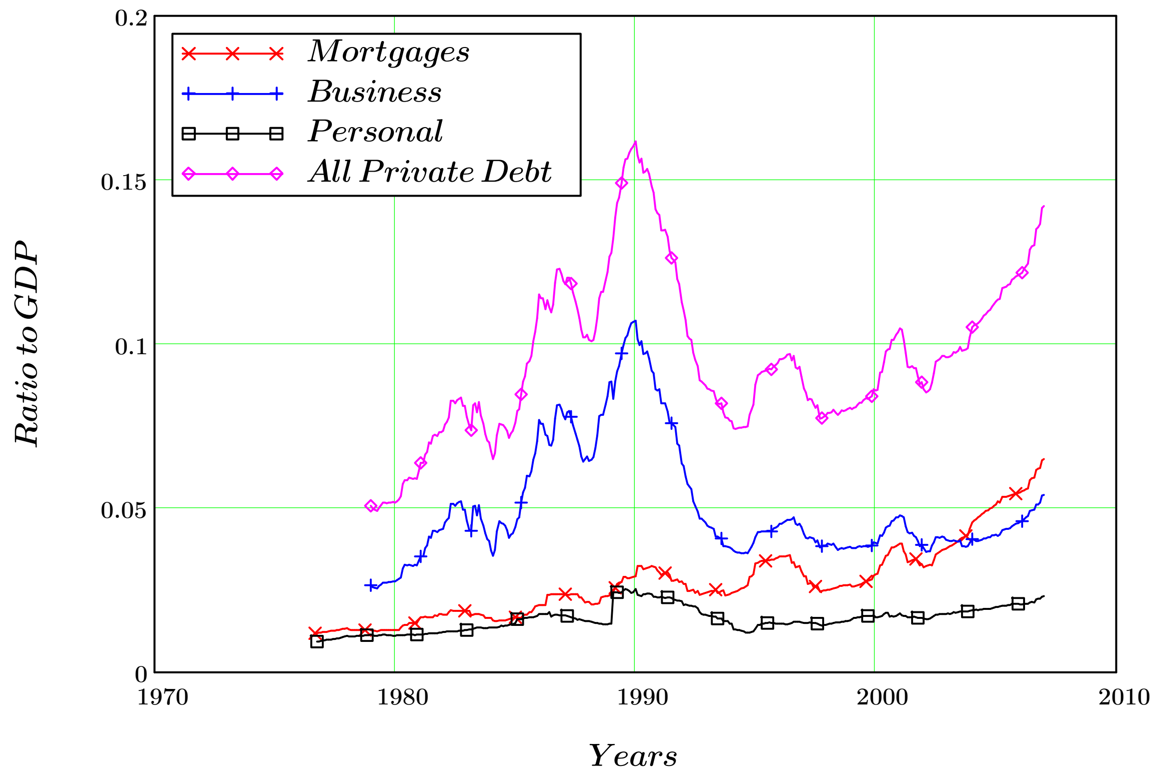
This is why both debt levels and interest rates have to fall in the near future--the combination of the two is at close to unsustainable levels, as a repeat of my "chart of the month" shows. Both interest rates and the debt level contribute to the debt repayment burden, and the curves indicate combinations of interest rates and debt levels that result in the same proportion of GDP being needed to service debt. The level that led to the last recession was the outermost curve, where the interest bill represents 16% of GDP.

We hit that level--and plunged rapidly into recession--in 1990, with interest rates of 20 per cent and a debt ratio of 81%. Now we are approaching that line of pain again, with much lower interest rates.

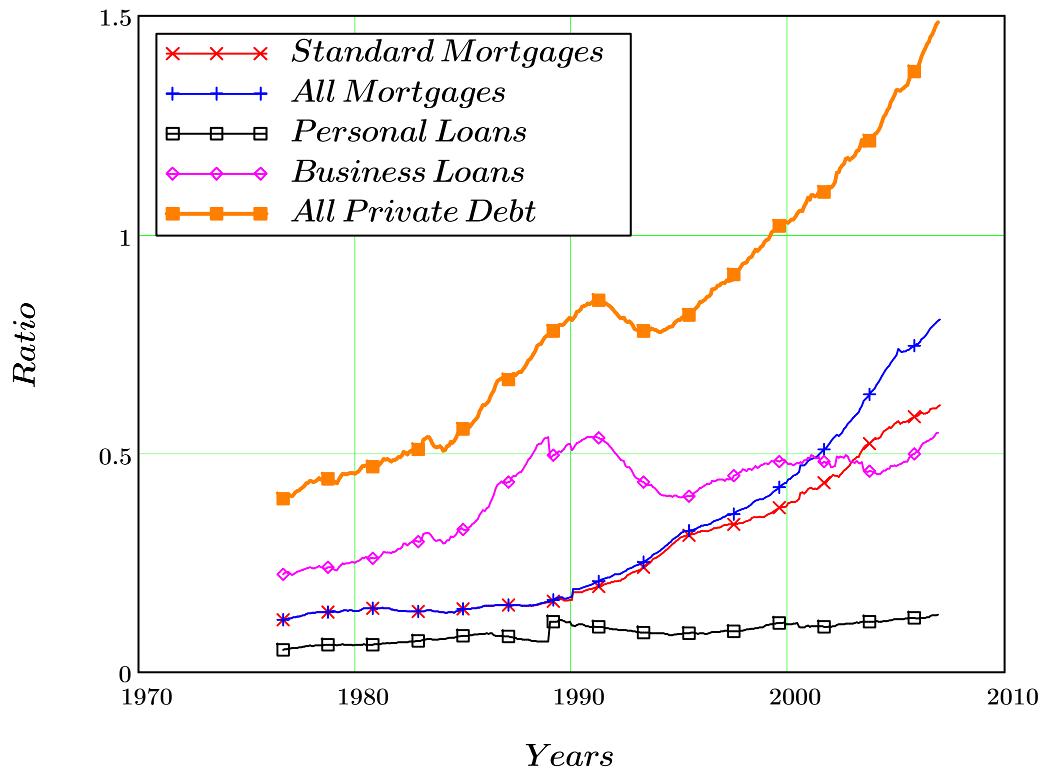
Taking 8% as the level at which an economic revival can occur (since that was the level where the current economic recovery began in 1994) either average interest rates have to fall to 5.3%, or debt levels have to fall to 95% of GDP, or some combination of the two must apply.



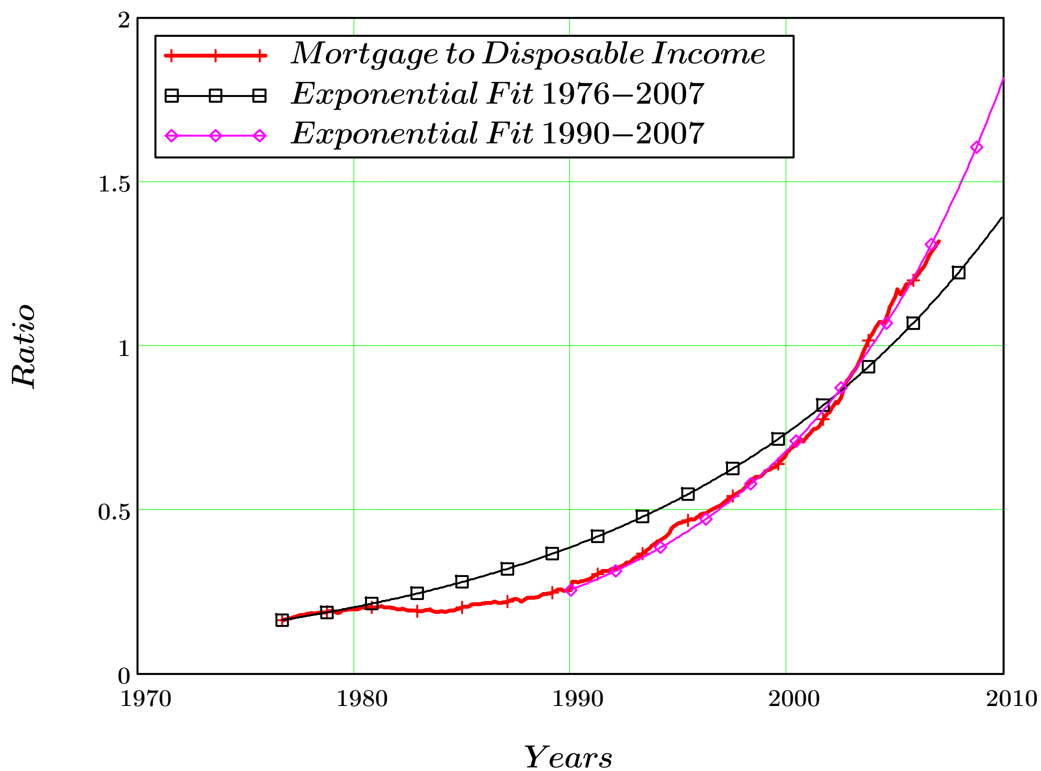
When the next recession hits, the pain will first fall on the household sector--in contrast to the 1990s recession, when the household names of the crash were Bond and Skase rather than Jones and Nguyen. Mortgage interest payments represent 6.5% of GDP, and personal loan interest another 2.3% for a total household interest payment burden of 8.8% of GDP. This is well below the 10.7% level that business interest payments hit with the sky-high interest rates of 1990, but well above the 5.4% level that business has to carry today.



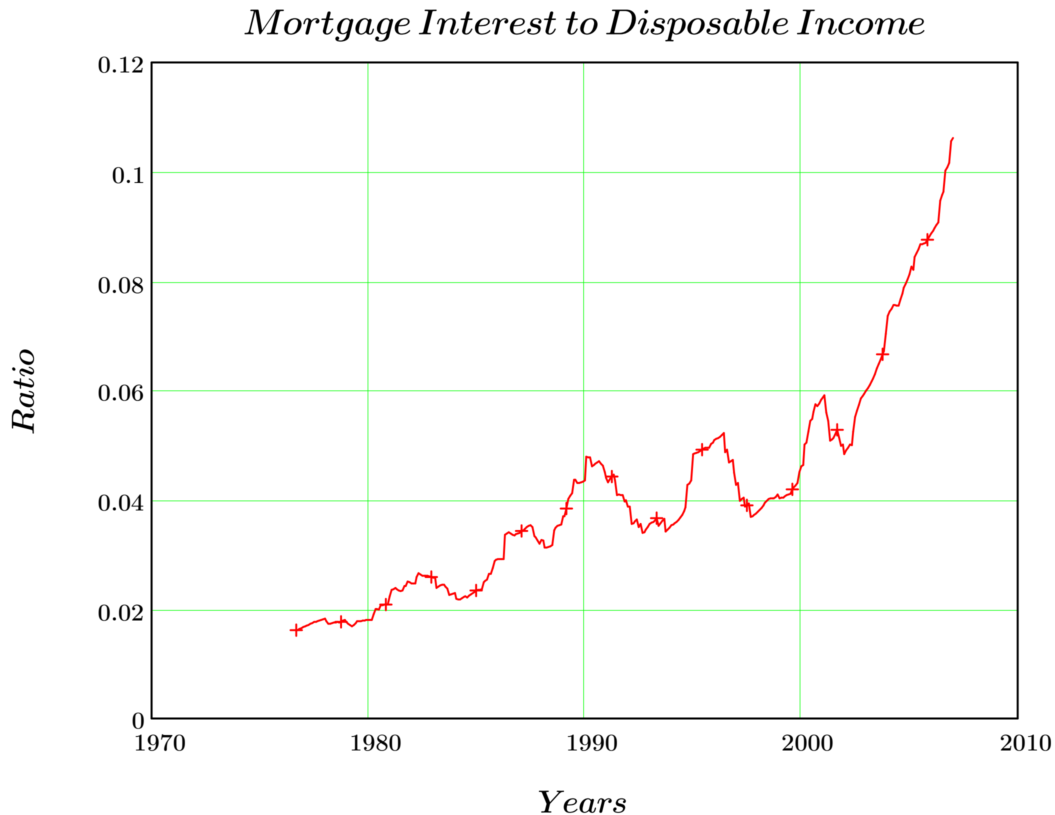
The switch from corporations to households has occurred because, while businesses realised that they had overextended themselves in the 1990s, households went on a borrowing binge that was ostensibly all about "securing the future" through leveraged investment in property. As should be obvious now, the main outcome of that binge was an unsustainable rise in residential property prices--after all, it did little to provide rental properties, given that we are now suffering from a critical shortage of rental properties in Sydney just two years after the binge ended.



Mortgage debt has more than quadrupled compared to household disposable income in the last seventeen years: it was just 26% of household disposable income in 1990, and is now 132%:

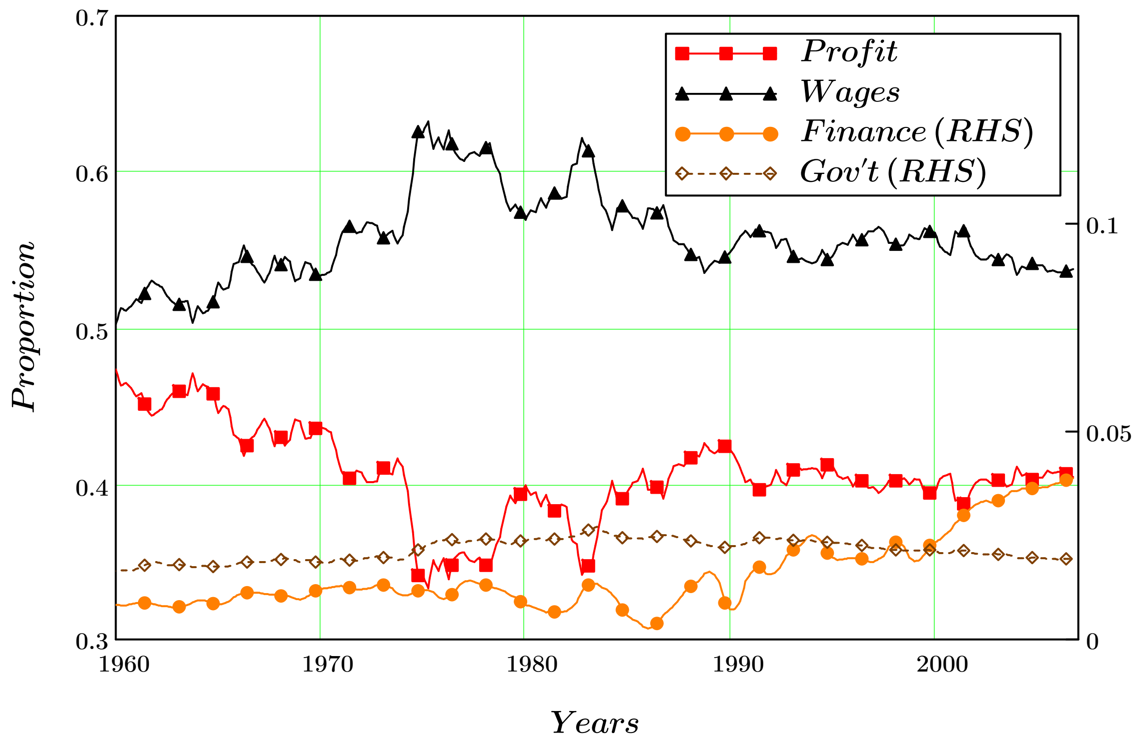


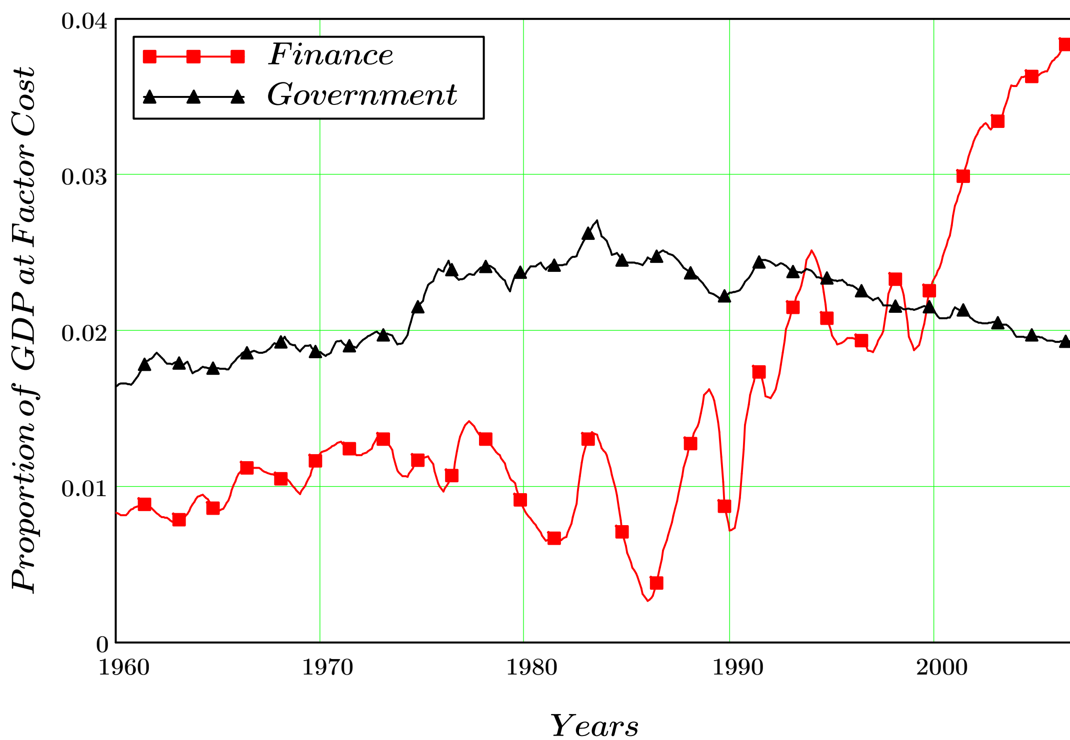
Households now need to devote more than ten per cent of their disposable incomes to paying mortgage interest.



The growth in debt has caused an historic change in the distribution of income in Australia. For the past 50 years, the income distribution battle has been the workers versus the bosses--with the workers winning round one up until 1973, and the bosses holding the upper hand ever since.

Rentiers were largely bystanders in this battle, with financial income averaging 1% from 1960 till 1990. But since 1990, rentier income has taken centre stage. While profit has remained relatively constant as a share of factor incomes from 1990 till now, workers incomes have continued to slide and the difference has gone to rentiers. Rentier income has exploded from 1% of factor incomes in 1990 to almost 4% today.


Shares of Factor Incomes
Profit
Wages
Finance (RHS)
Gov't (RHS)
Proportion
Years
0.7
0.6
0.5
0.4
0.3
0.1
0.05
0
1960
1970
1980
1990
2000


Shares of Factor Incomes: the Finance Blowout
Finance
Government
Proportion of GDP at Factor Cost
Years
0.04
0.03
0.02
0.01
0
1960
1970
1980
1990
2000