

Steve Keen's DebtWatch No 22 May 2008

Defer the RBA "Enhanced Independence" Act

The *Reserve Bank Amendment (Enhanced Independence) Bill 2008*, which was tabled in Parliament in March, aims to give the RBA Governor and Deputy Governor "the same level of statutory independence as the Commissioner of Taxation and the Australian Statistician" (Wayne Swann, Hansard, Thursday, 20 March 2008, p. 2381).

Under the current Reserve Bank Act, the Governor and Deputy are appointed by the Treasurer, and the Treasurer **must** remove them from their positions if either of them:

*"(a) becomes permanently incapable of performing his or her duties; or
(b) engages in any paid employment outside the duties of his or her office; or
(c) becomes bankrupt, applies to take the benefit of any law for the relief of bankrupt or insolvent debtors, compounds with his or her creditors or makes an assignment of his or her salary for their benefit;"*

Under the Amendment:

The Governor General replaces the Treasurer as the appointer (and terminator);

- their removal under those same three conditions becomes optional rather than compulsory--the wording changes from "the Treasurer **shall** terminate his appointment" to "The Governor-General **may** terminate the appointment"; and
- there is a procedure that must be followed for that option to be exercised:
 1. Firstly the Governor-General has to *suspend* the RBA Governor or Deputy, on one of the three grounds;
 2. Within 7 days of that, the Treasurer has to give both Houses a statement justifying the suspension;
 3. Within 15 days of that, each House has to vote to approve terminating the appointment; and
 4. If either House votes against termination, the suspension is revoked and the appointment continues.

There are some "Gilbert and Sullivan" aspects to this Amendment--we could, for example, have a comatose and bankrupt Governor kept in office indefinitely by a hung Parliament. But leaving aside even that eventuality, the principle underlying the Amendment is flawed. Though the aim to put monetary policy above politics is noble, the faith it puts in economics is misguided. Economists--even those running the Reserve Bank--do not deserve the status this Act gives them.

There are good reasons to put the Tax Commissioner above politics. We don't want a Tax Commissioner using the office to run political vendettas (and the tax laws the Commissioner enforces are passed by Parliament anyway, so in that sense the office is under political control).

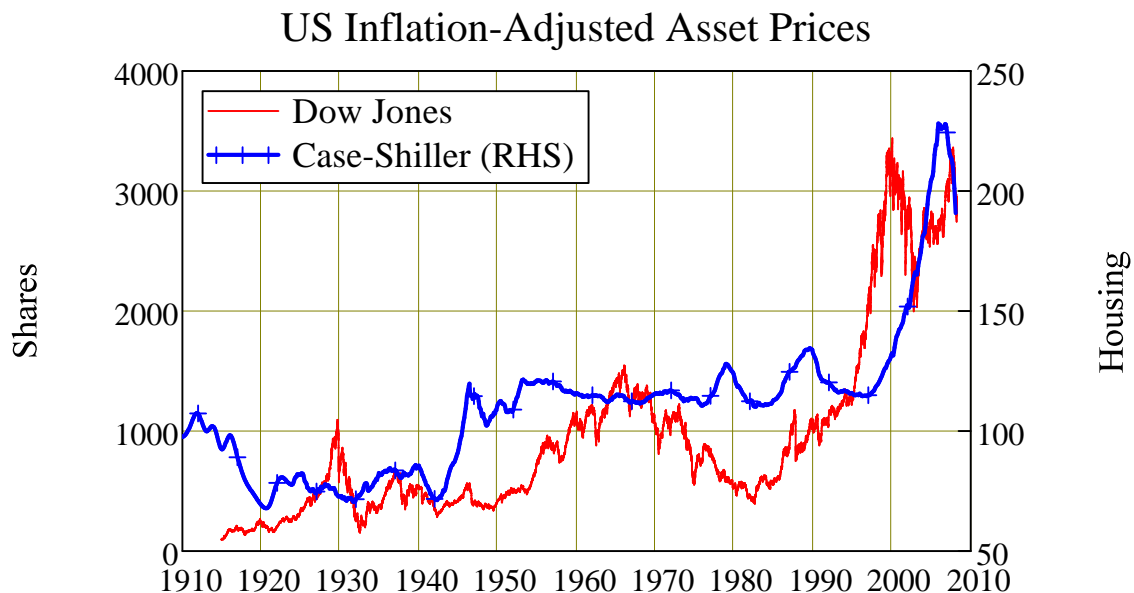
Equally, no-one wants a official statistician who is subject to political pressure--a good look at Stalin's Russia shows where that might lead. The process of collecting and interpreting statistical data is also a well-established science.

Therein lies the rub: economics is **not** a well-established science, but this Act treats economics as if it were one.

If it were, then the Act would make sense. Then, only economists should control the economy--just as only physicists should run a nuclear power station. But economists don't understand the economy anywhere near as well as physicists understand nuclear fission. Far from preventing economic meltdowns, economists can cause them, by applying theories about how the economy works that are, in fact, wrong.

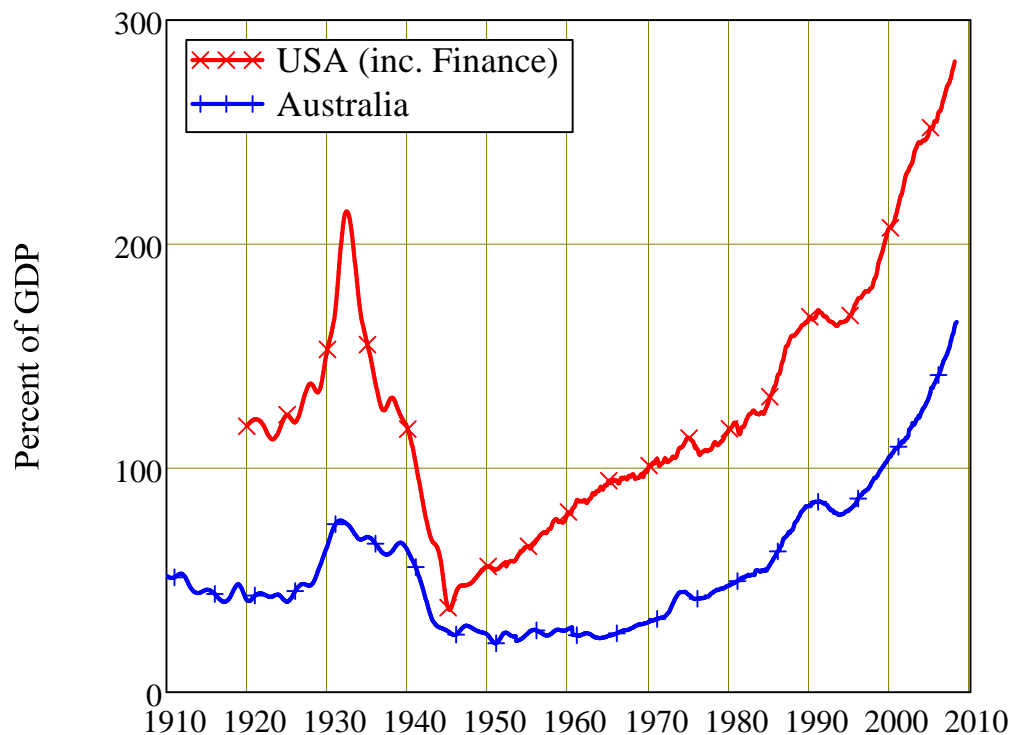
Of course, physicists can make mistakes, and the inherent safety of nuclear power is a matter of debate. But even critics of nuclear power have to admit that nuclear accidents have been a lot rarer than financial crises.

Now look at the current state of world financial markets, and ask yourself whether they resemble a well-functioning reactor, or Chernobyl on a bad day. Since the mid-1990s--when Central Banks have been more independent of government control than at any time in history----asset markets have reached stratospheric levels of over-valuation. If Central Banks were supposed to be managing the nuclear reactors of finance, then they have taken the control rods out and let the system go gangbusters.



The fuel that has fed this nuclear fire is private debt, which has risen at a faster rate than ever, and to levels that are unprecedented in human history. What was a fun ride on the way up promises to be anything but fun on the way down.

Private Debt to GDP



Obviously many parties share responsibility for this mess, but without doubt economists--**including Central Bankers**--shoulder a large part of the blame.

Firstly, the last two decades have been a period of unprecedented independence for Central Banks. After the high inflation of the 1970s and 80s, when politicians were last in direct control of monetary policy, politicians willingly ceded control to the Central Bankers--largely to avoid the political pain of being blamed for high interest rates.

Inflation has certainly been lower since the Central Bankers took over, but at the same time there have been more--and ever larger--financial crises than when politicians held the reins. We've had the Asian Financial Crisis (1997), the Russian Financial Crisis (1998), the Long Term Capital Management Financial Crisis (1998), the Internet Bubble and NASDAQ Financial Crisis (2000), and now, the Subprime Financial Crisis--all since Central Banks cast off the shackles of political control.

That's not a track record that inspires the confidence in Central Bankers. I'd be inclined to give them less independence, rather than more, on that evidence alone.

Secondly, **economic theory itself** has contributed to the financial excesses that caused these crises. Economists developed models of how markets were supposed to behave--such as the "Efficient Markets Hypothesis"--that championed the explosive growth of financial markets. Yet these theories were wildly inaccurate models of how markets actually behave.

When put into practice, these theories gave us products--such as derivatives--that were supposed to help investors hedge against uncertainty, but were instead used for leveraged gambling. They gave us policies--such as deregulation--that were supposed to lead to greater efficiency, and instead caused speculative bubbles.

The same will prove to be true of the RBA's current emphasis upon controlling the rate of inflation using interest rates. I expect this policy--which is based on an economic model known as the Taylor Rule--to fail in several important ways:

It will, as happened with high interest rates in the '90s, make the approaching recession worse;

It will fail to control inflation anyway, since many of the causes of inflation are immune to movements in Australia's interest rates; and

It downplays the importance of the over-arching need to ensure the soundness of the financial system, at a time when the system is more fragile than it has been since the Great Depression.

I am certainly **not** saying that politicians would have done a better job of managing monetary policy than economists in the last two decades. Political policies like the Howard Government's doubling of the First Home Buyers Grant, and halving the rate of capital gains tax, definitely stoked the speculative fire beneath Australian house prices earlier this decade.

But at least politicians are ultimately accountable. This Act would put economists above accountability, not so much to politicians, but to the Australian people.

Of course, I could be wrong, and the Reserve could be right. Events could prove its focus on fighting inflation to be correct, and experience could thus show that the RBA deserves more independence than it currently has. So *let's defer this Act until we know **from experience** that this is the best way to manage monetary policy.*

Fortunately, the sky won't fall in if the Amendment is passed. It leaves intact the provisions of Section 11, which allow the government to compel the RBA to undertake a different policy than the one it wants to follow. So monetary policy could still be taken out of the hands of the RBA, if a serious disagreement developed over what to do in an equally serious economic crisis--and the politicians were courageous enough to call the experts to heel.

END OF COMMENTARY

Comment on Data

There are signs that Australia's debt bubble is finally approaching bursting point. Though debt is still rising faster than GDP, the rate of increase is slowing--and even on the aggregate debt to GDP chart below, there are signs of a turn towards what Michael McNamara of Australian Property Monitors so aptly christened "Peak Debt".

If we are indeed approaching "Peak Debt", then it will be the third such mountain in Australia's economic history--the other two being 1892 and 1931 respectively. This still-growing Peak, however, already dwarfs the other two. The fact that debt has reached such towering proportions during a period when Central Banks (and other regulators) are supposed to be exercising prudential control over the financial system is one of the main reasons that I am opposed to granting them any more independence

Last month, aggregate private debt rose by 0.86 percent--still faster than the monthly rate of growth of nominal GDP (running at 0.59 percent), but not overwhelmingly so, as has been the rule for the previous fifteen years. Significantly, personal debt fell for the third month running (though business and mortgage debt continued to rise). It appears that Australian households might be finally trying to bring debt under control, starting with its most expensive component.

If a slowdown is finally happening, then--though in a financial sense that is a good thing--there may well be an "inexplicable" decline in economic activity in its wake. Since aggregate spending is the sum of income plus the **change** in debt, when that change in debt slows down, so does demand. Since the change in debt last year accounted for 19.4 percent of aggregate spending, any slowdown will hit spending--on asset markets, or consumption, or both--like a brick.

Chart One

Debt and Politics

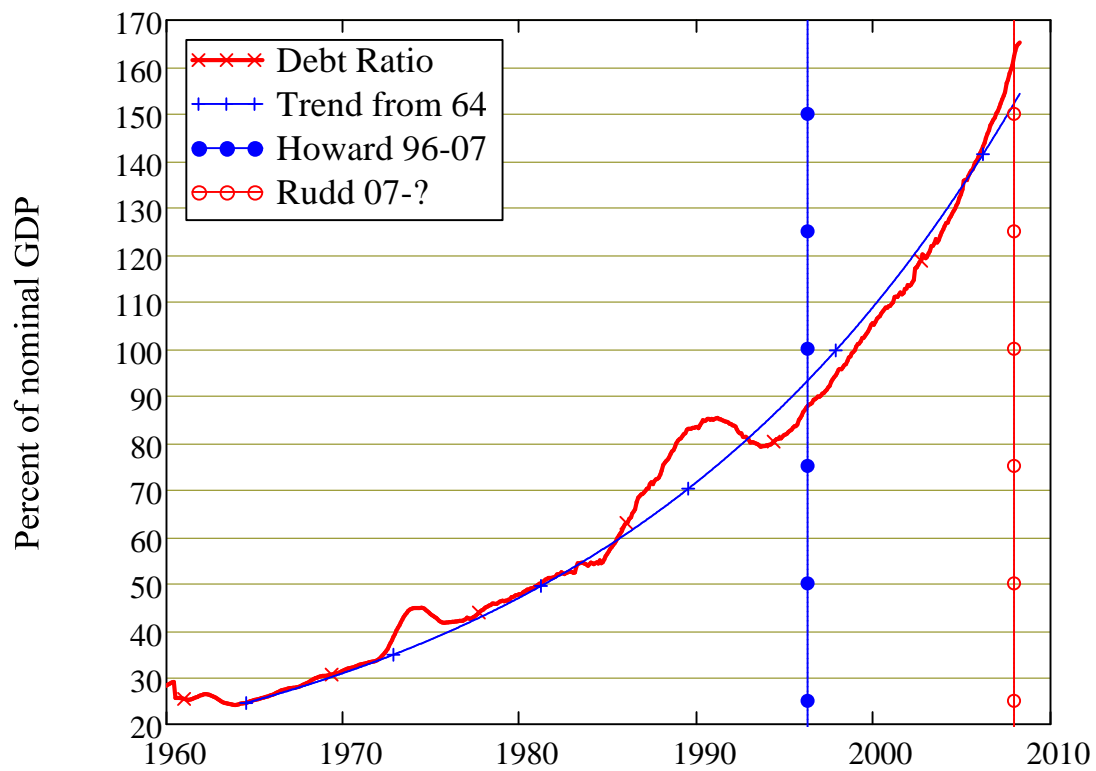


Chart Two

Long Term

Debt to GDP: The Long Term View

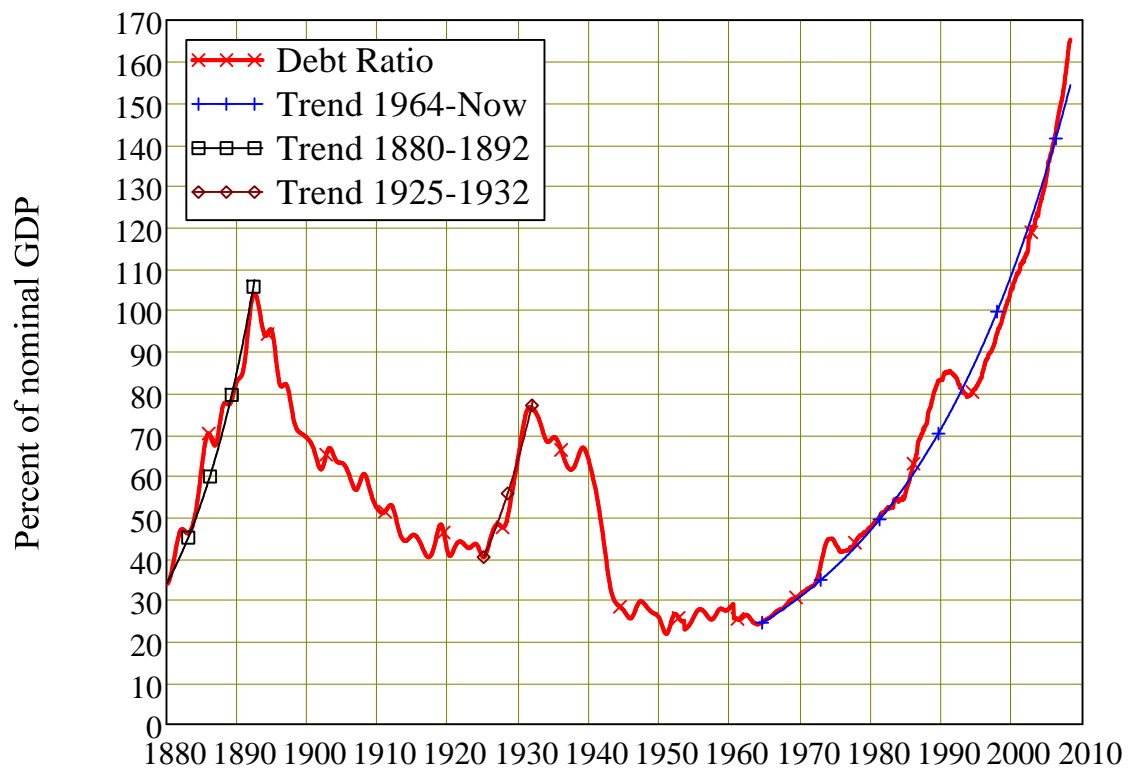


Table One: Aggregated Debt Summary

Table One

	0	1	2
0	"Summary"	"Total Private Debt"	"Nominal GDP"
1	"Date (levels)"	2008.25	2008
2	"Levels (\$m)"	1821664	1083793
3	"Change Month \$m"	13683	6341.42
4	"Change Month %"	0.76	0.59
5	"Change Year \$m"	253742	80347
6	"Change Year %"	16.18	8.01
7	"Since 1990"	8.76	5.45
8	"Since 1980"	12	7.91
9	"Since 1964"	13.47	9.38
10	"Date (% GDP)"	2008.25	"N/A"
11	"As % of GDP"	165.25	100
12	"Change Month"	0.2	"N/A"
13	"Change Year"	7.94	"N/A"
14	"Since 1990"	3.02	"N/A"
15	"Since 1980"	4.13	"N/A"
16	"Since 1964"	4.19	"N/A"

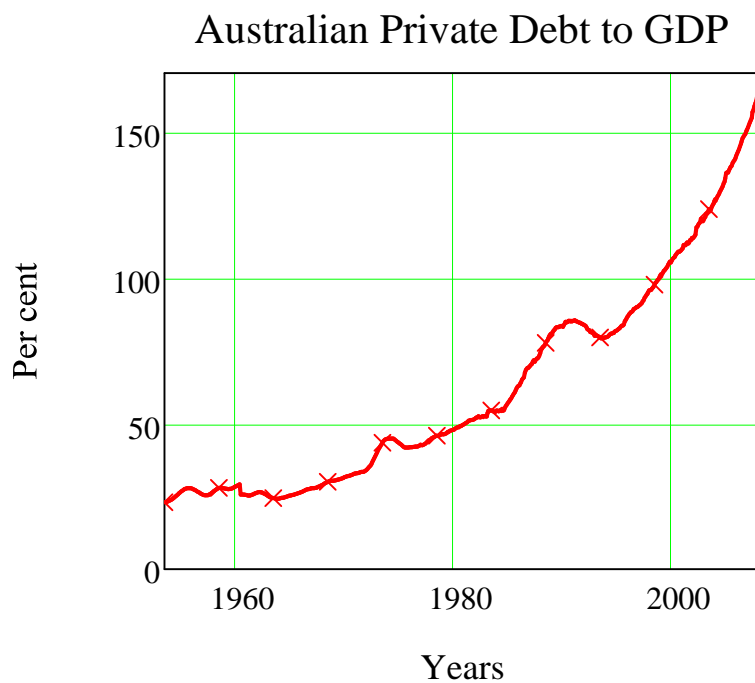
Table Two: Disaggregated Debt Summary

Table Two

	0	1	2	3
0	"Detail"	"Business"	"Mortgage"	"Personal"
1	"Levels (\$m)"	728012	940185	153465
2	"Change Mth \$m"	6217	7838	-373
3	"Change Mth %"	0.86	0.84	-0.24
4	"Change Yr \$m"	141941	96212	15587
5	"Change Yr %"	24.22	11.4	11.3
6	"Since 1990"	5.23	13.37	5.64
7	"Since 1980"	10.66	13.08	10.46
8	"Since 1976"	11.17	13.45	11.22
9	"As % of GDP"	66.04	85.28	13.92
10	"Change month"	0.3	0.28	-0.8
11	"Change year"	15.4	3.49	3.4
12	"Since 1990"	-0.6	9.15	-0.27
13	"Since 1980"	3.02	6.04	2.64
14	"Since 1976"	3.09	5.81	3.01

 $D_2 =$ **Debt to Income Ratios**

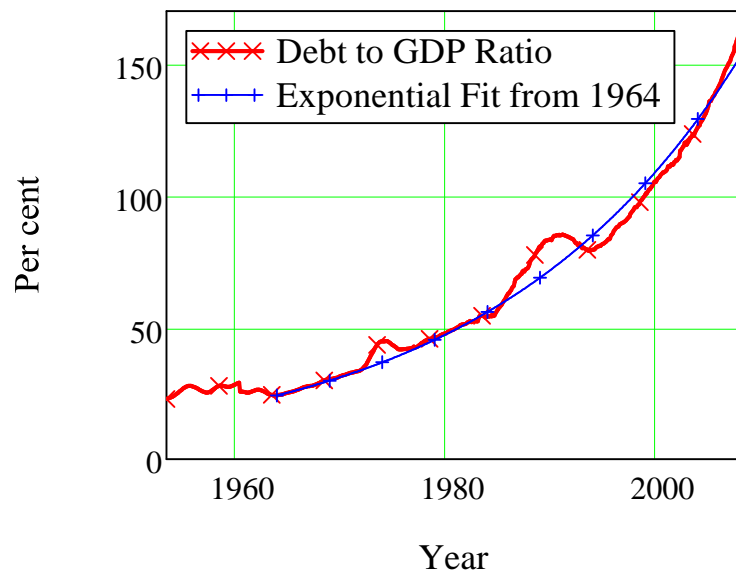
▣ Debt to GDP (D02 & G12)

Figure 1

▣ Debt to GDP Regression

Figure 2

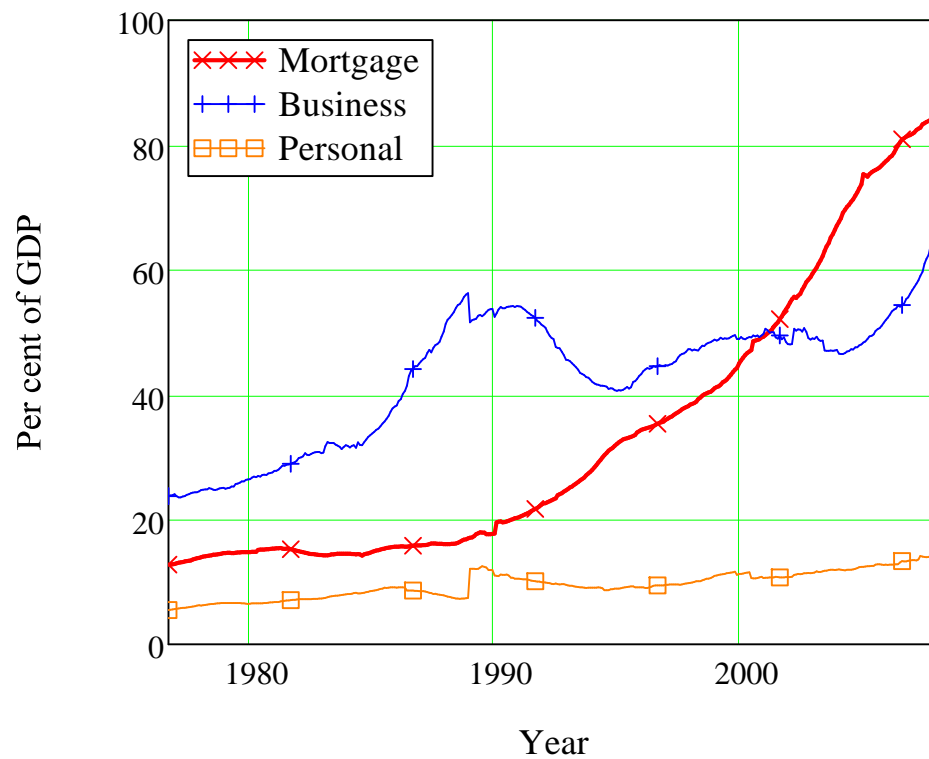
Australian Private Debt to GDP



▶ Debt Components to GDP

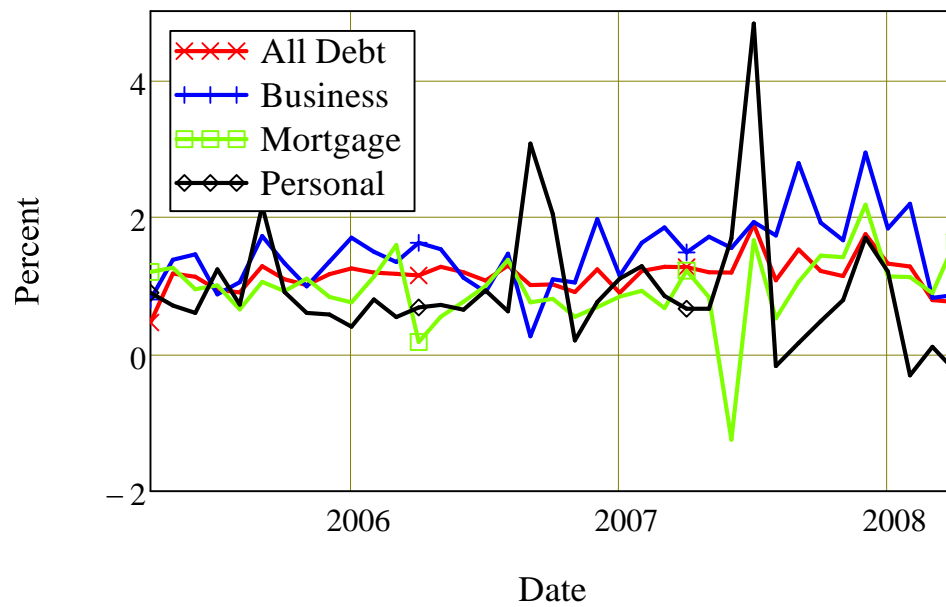
Figure 3

Components of Australian Debt



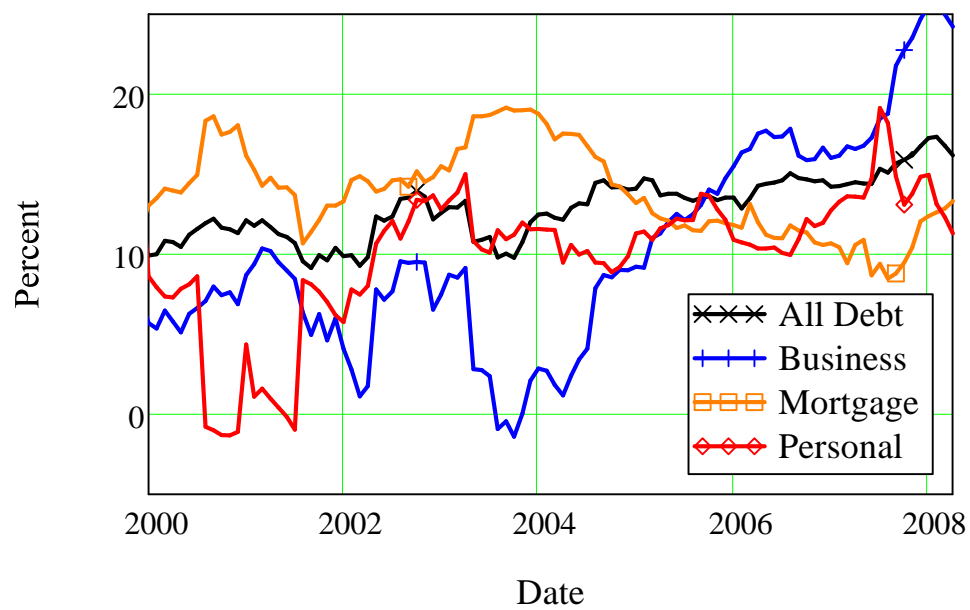
▶ Monthly Growth Rates

Debt Monthly Growth Rates



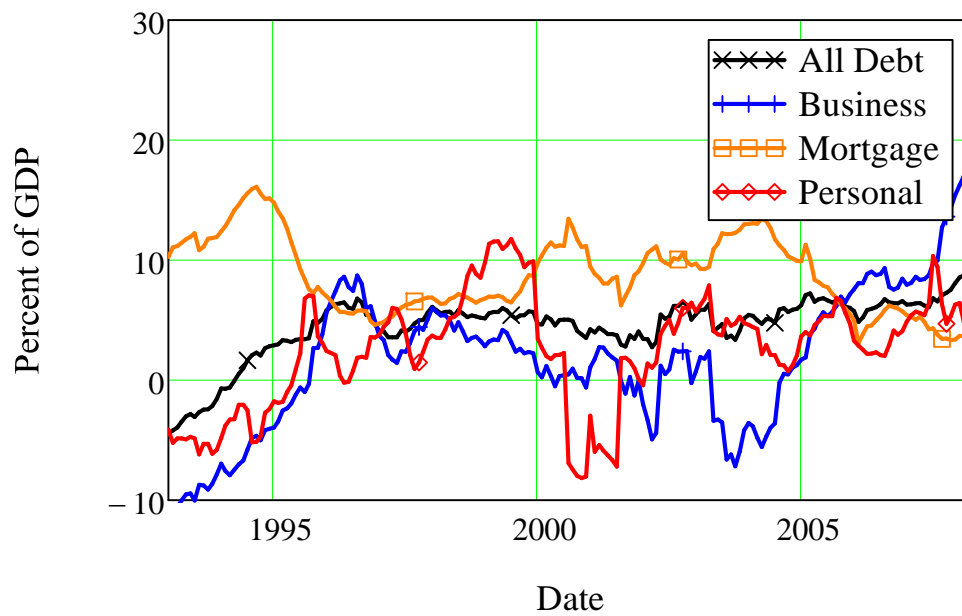
► Yearly Growth Rates

Debt Yearly Growth Rates



► Ratios Yearly Growth Rates

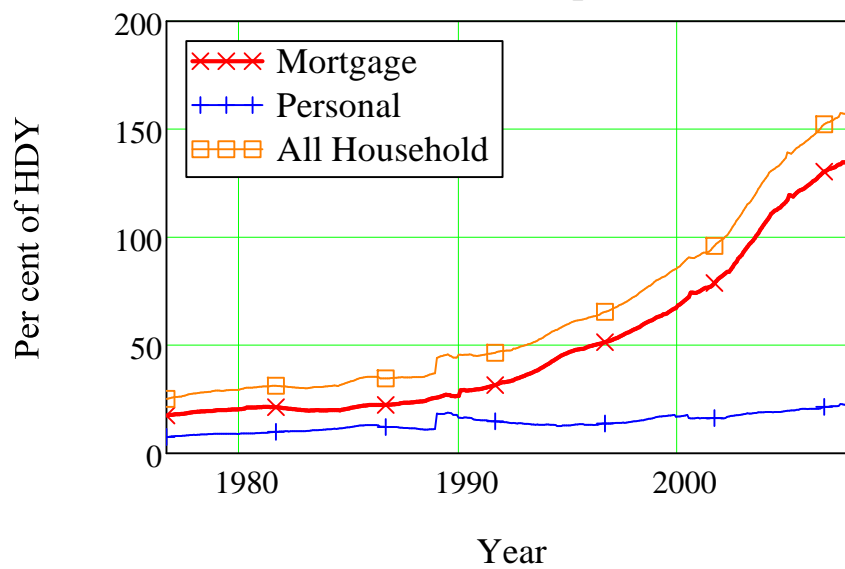
Debt Ratios Yearly Growth Rates



▶ Debt to Household Disposable Income

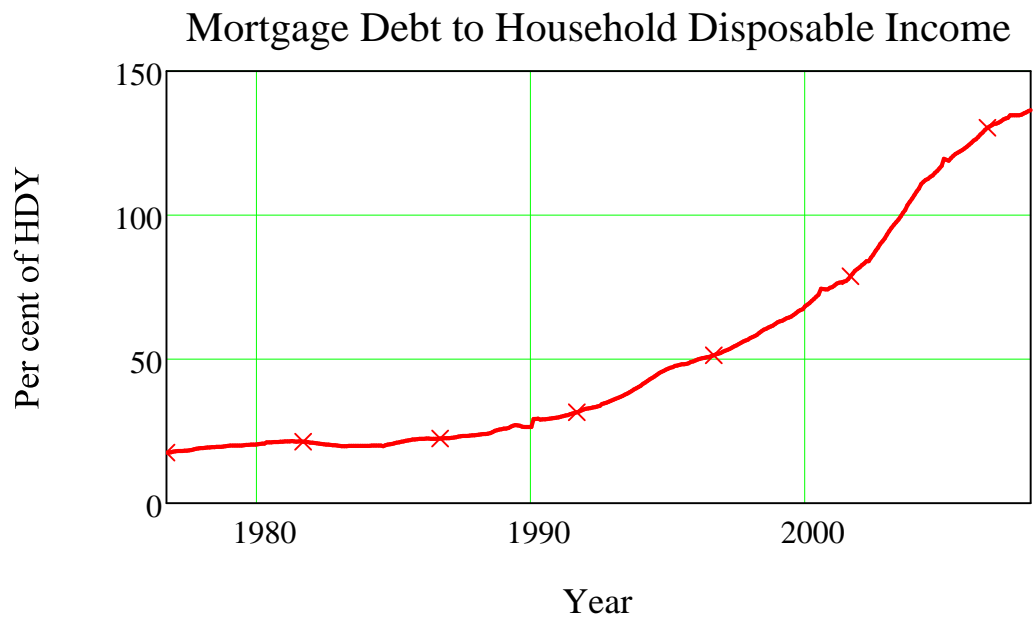
Figure 4

Household Debt to Disposable Income



▶ Mortgage Debt to Household Disposable Income

Figure 5



▶ 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).

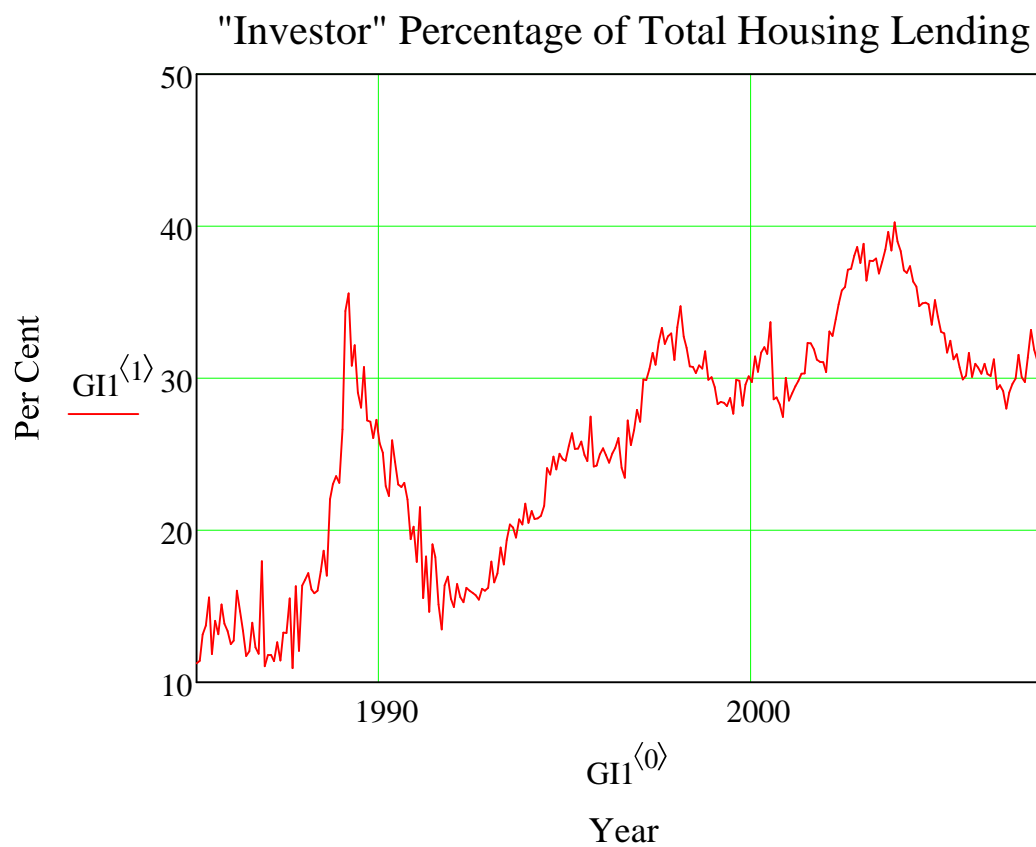
Figure 6



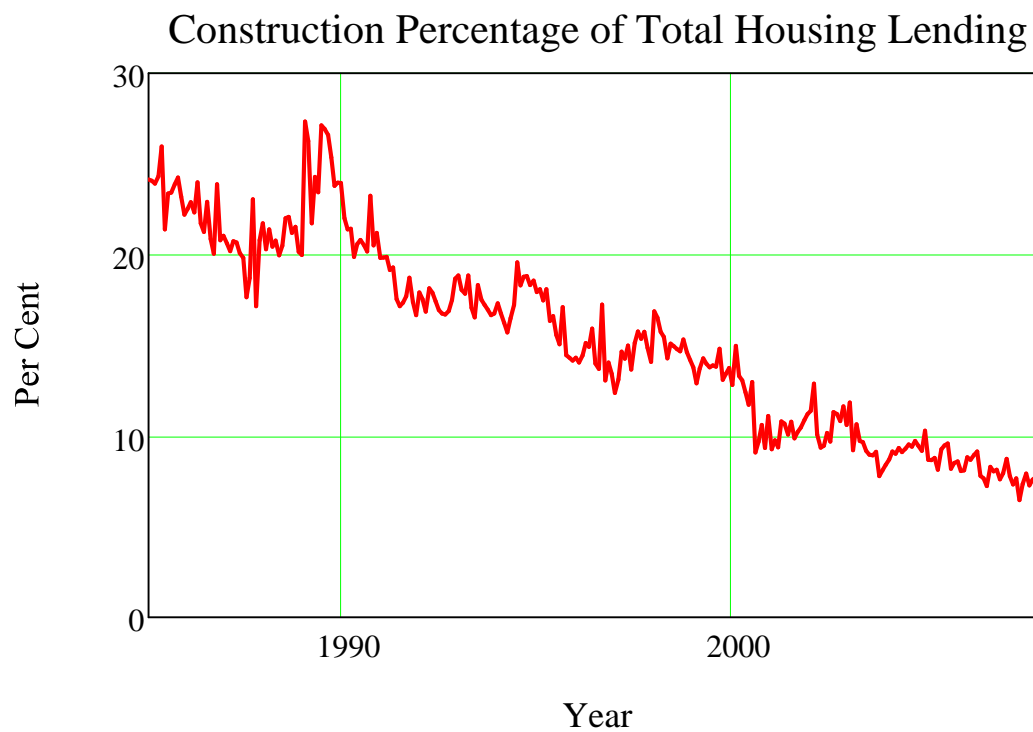
▶ Business Debt to GOS

Figure 7**Housing Finance Analysis**

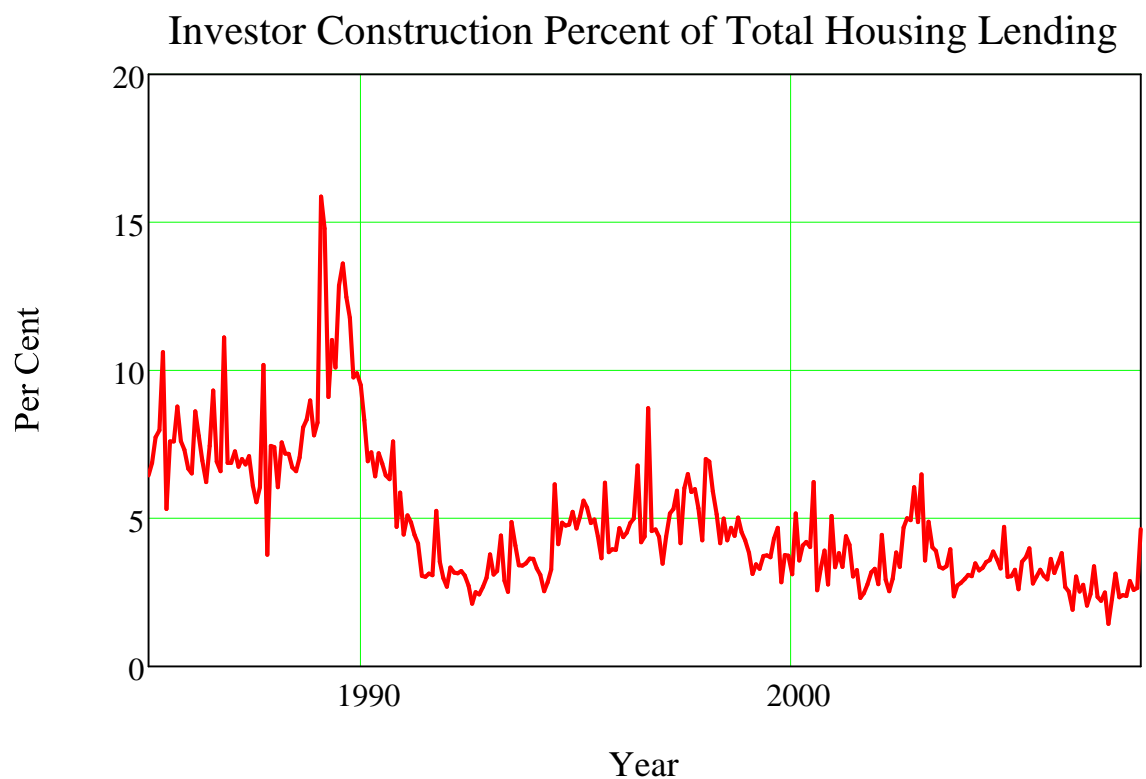
► Investment Percent Total Housing Lending

Figure 8

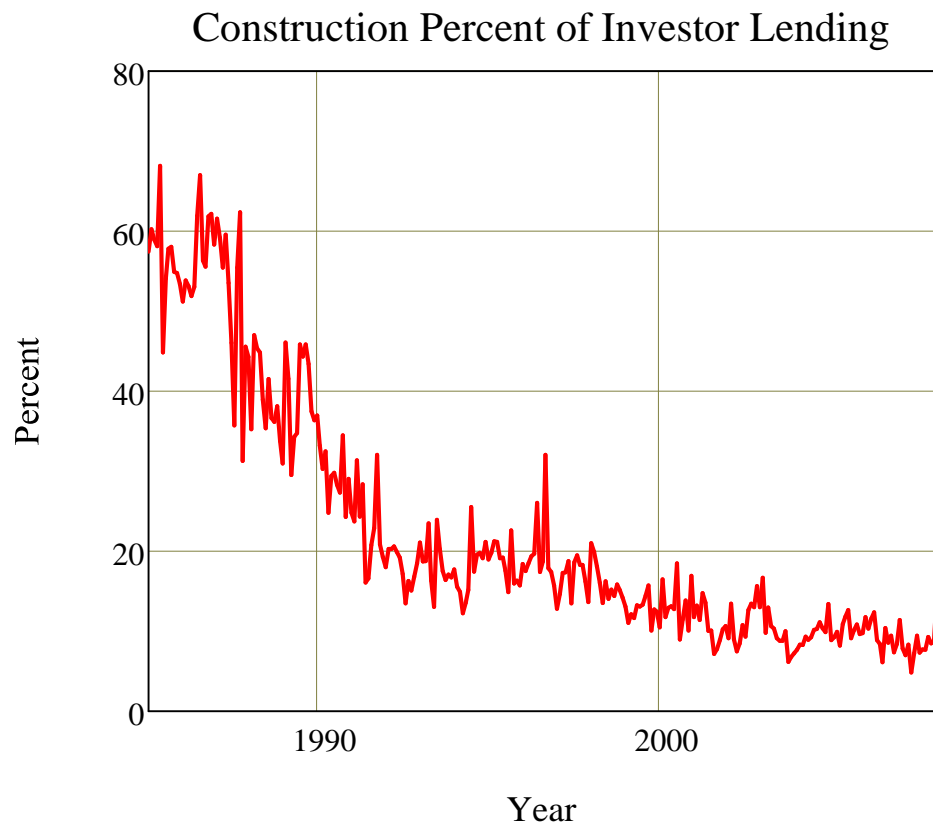
► Construction Percent Total Housing Lending

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

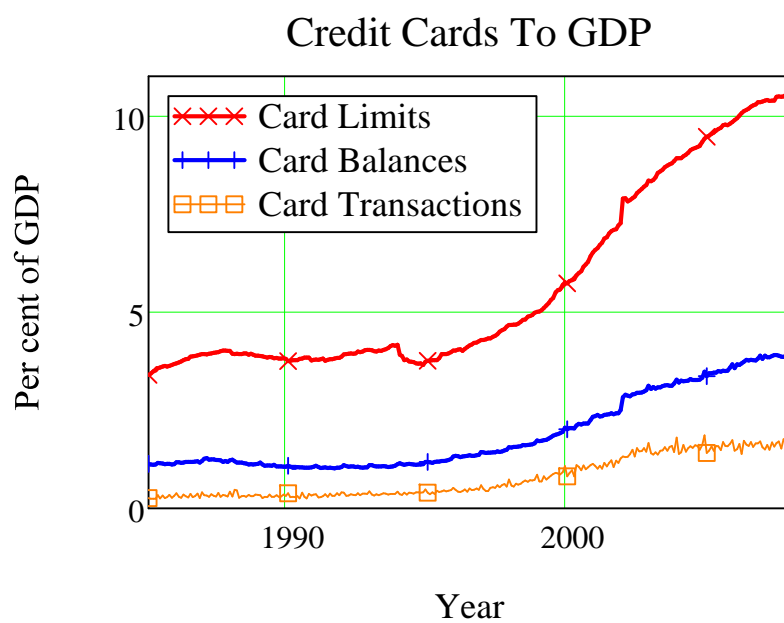
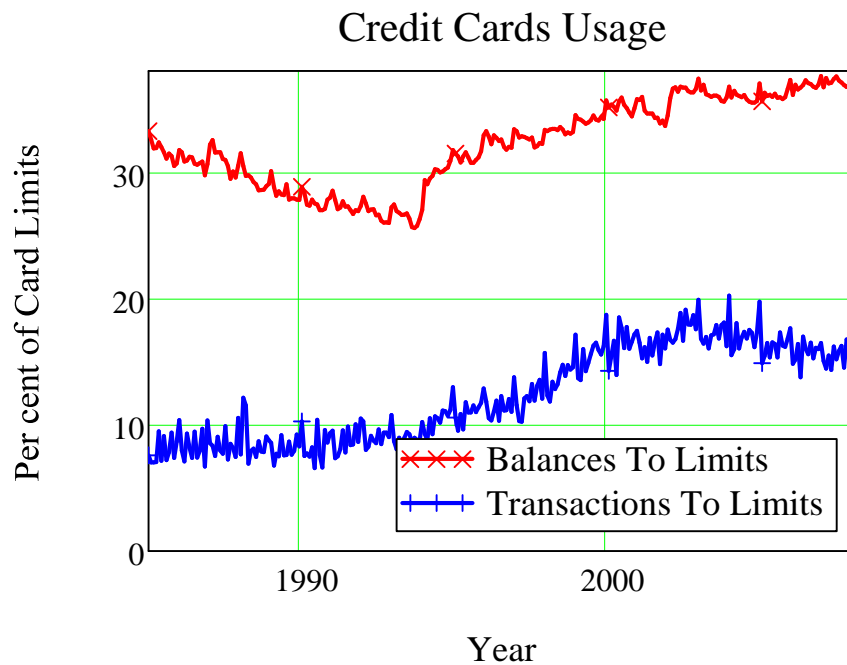
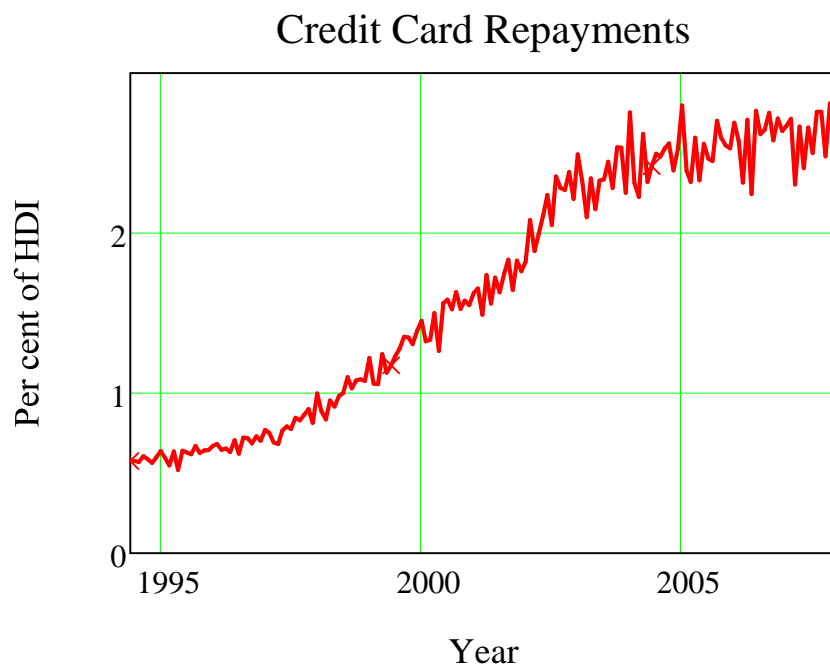


Figure 13

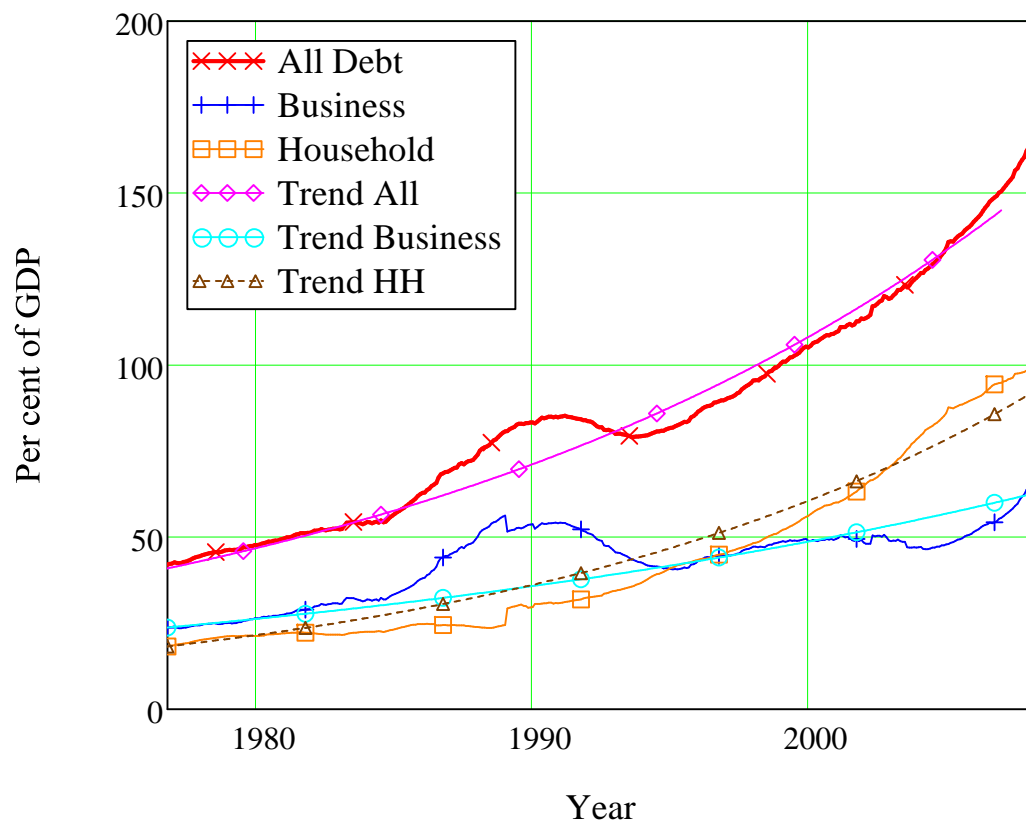
▶ Credit Card Data

**Figure 14**

▶ Credit Card Repayments



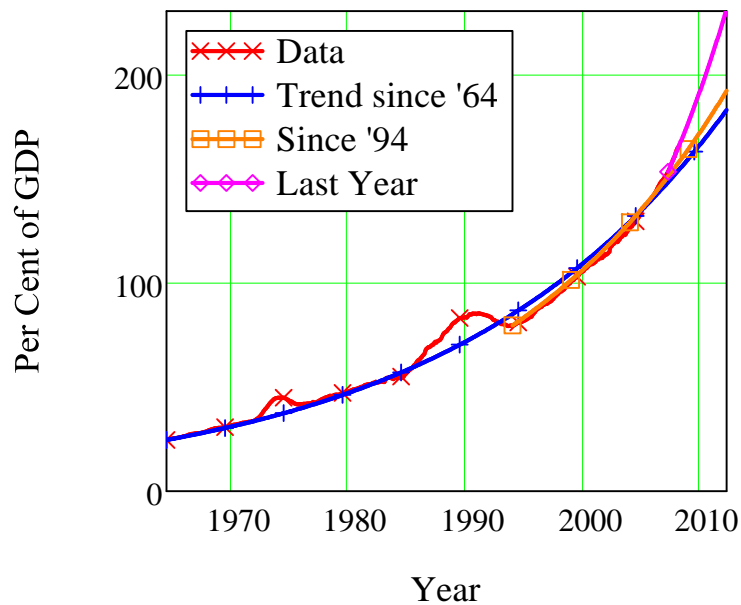
▶ Debt components to Income

Figure 14**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.

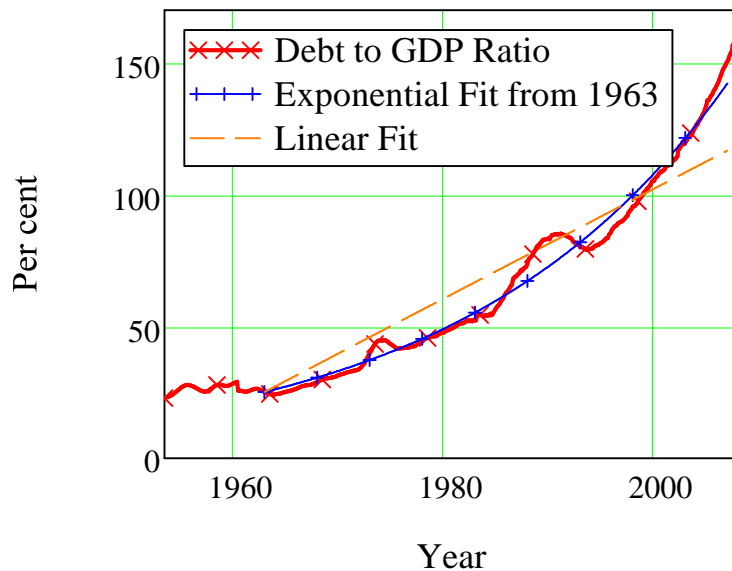
Table Three: Exponential Growth Rates & Correlations since 1964 & 1977

	0	1	2	3	4	5
Corr77 = 0	"Debt ratios"	"All"	"All"	"Business"	"Household"	"Mortgage"
1	"Start Date"	"mid-1964"	1977	1977	1977	1977
2	"Growth rate"	4.18	4.06	3.09	5.09	5.81
3	"Correlation"	99.12	98.44	73.37	98.13	98.34
4						

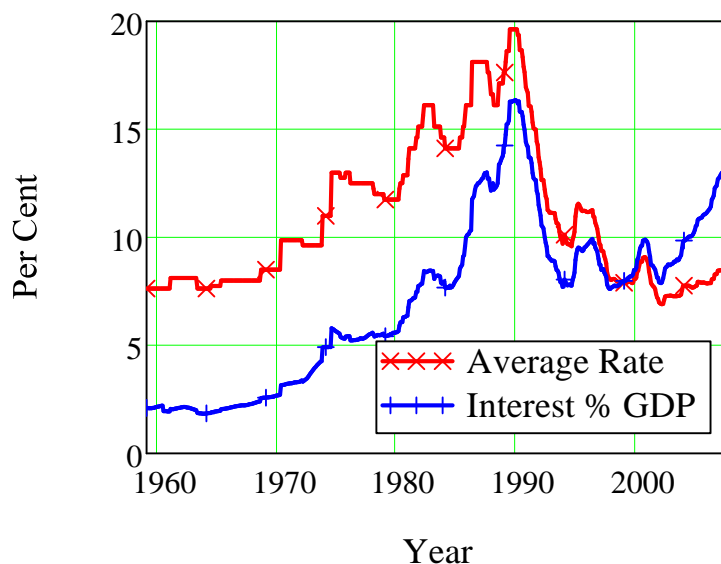
Table Four: Exponential Growth Rates & Correlations since 1990

	0	1	2	3	4
Corr90 = 0	"Debt ratios"	"All"	"Business"	"Household"	"Mortgage"
1	"Start Date"	1990	1990	1990	1990
2	"Growth rate"	2.81	-0.96	6.81	9.33
3	"Correlation"	96.48	-16.76	99.68	99.76

▶ Debt to GDP Linear vs Exponential Regressions

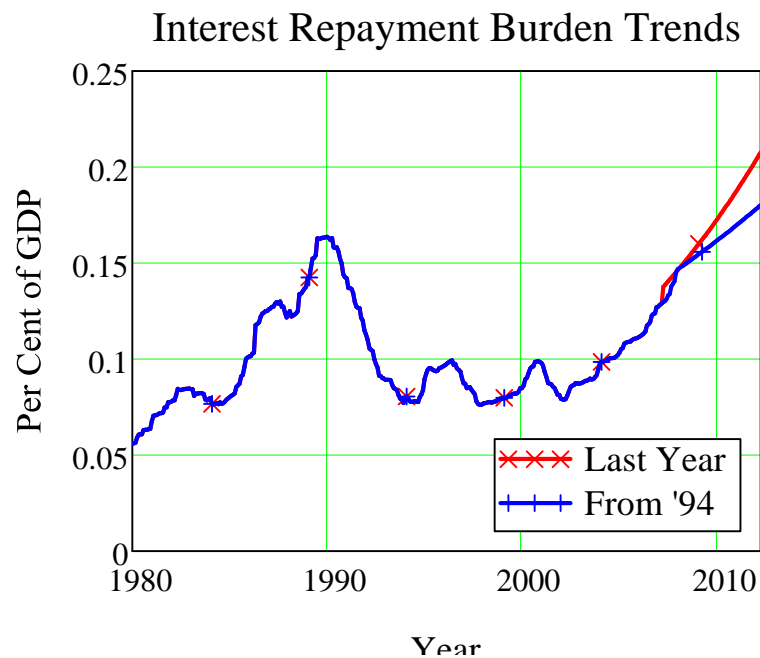
Figure 16**Australian Private Debt to GDP****Debt Servicing Burden**

▶ Interest Rates & Payments

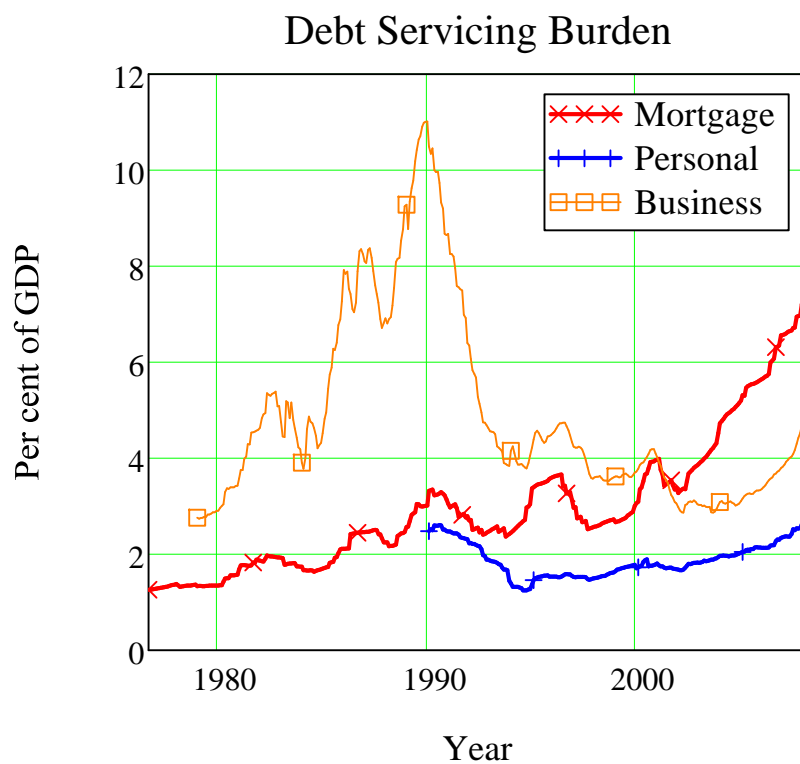
Figure 17**Interest Rates & Interest Burden**

▶ Interest Payment Trends

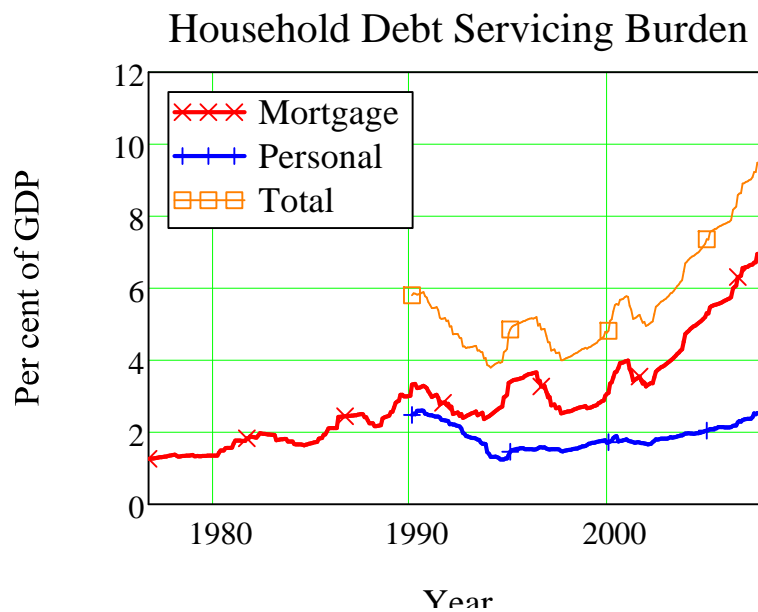
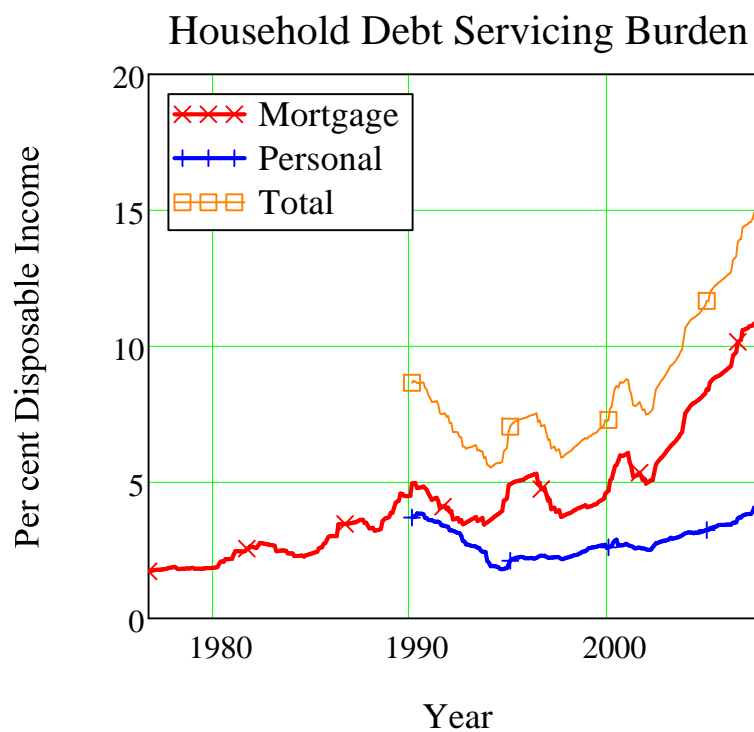
If trends in debt growth continue, then even without any increases in official interest rates, the interest repayment burden on the economy will exceed that of 1990 sometime between September 2008 and September 2009.

Figure 18

▶ Debt Servicing by Loan Type

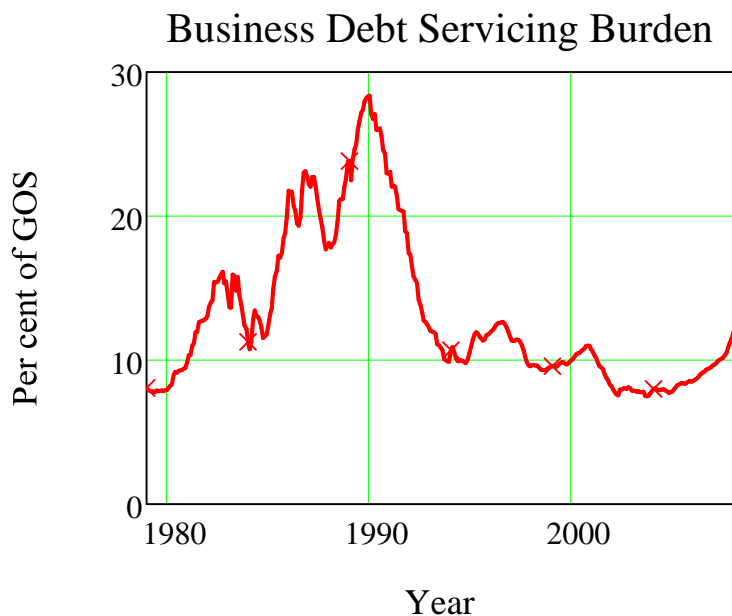
Figure 19

▶ 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

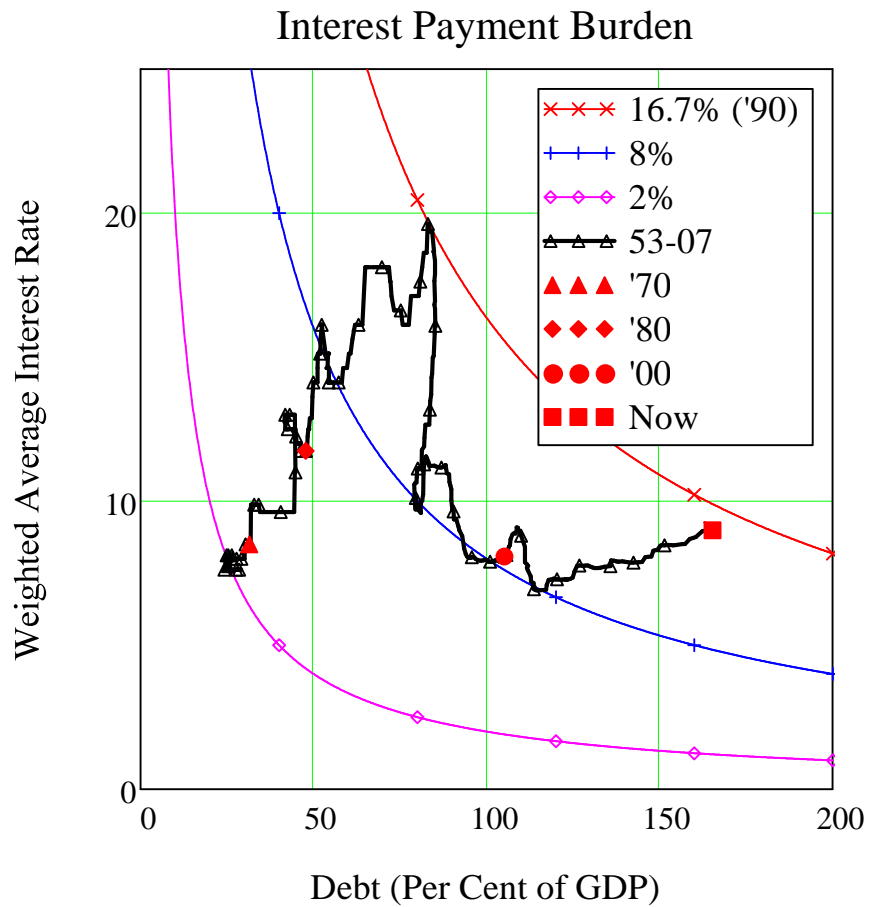
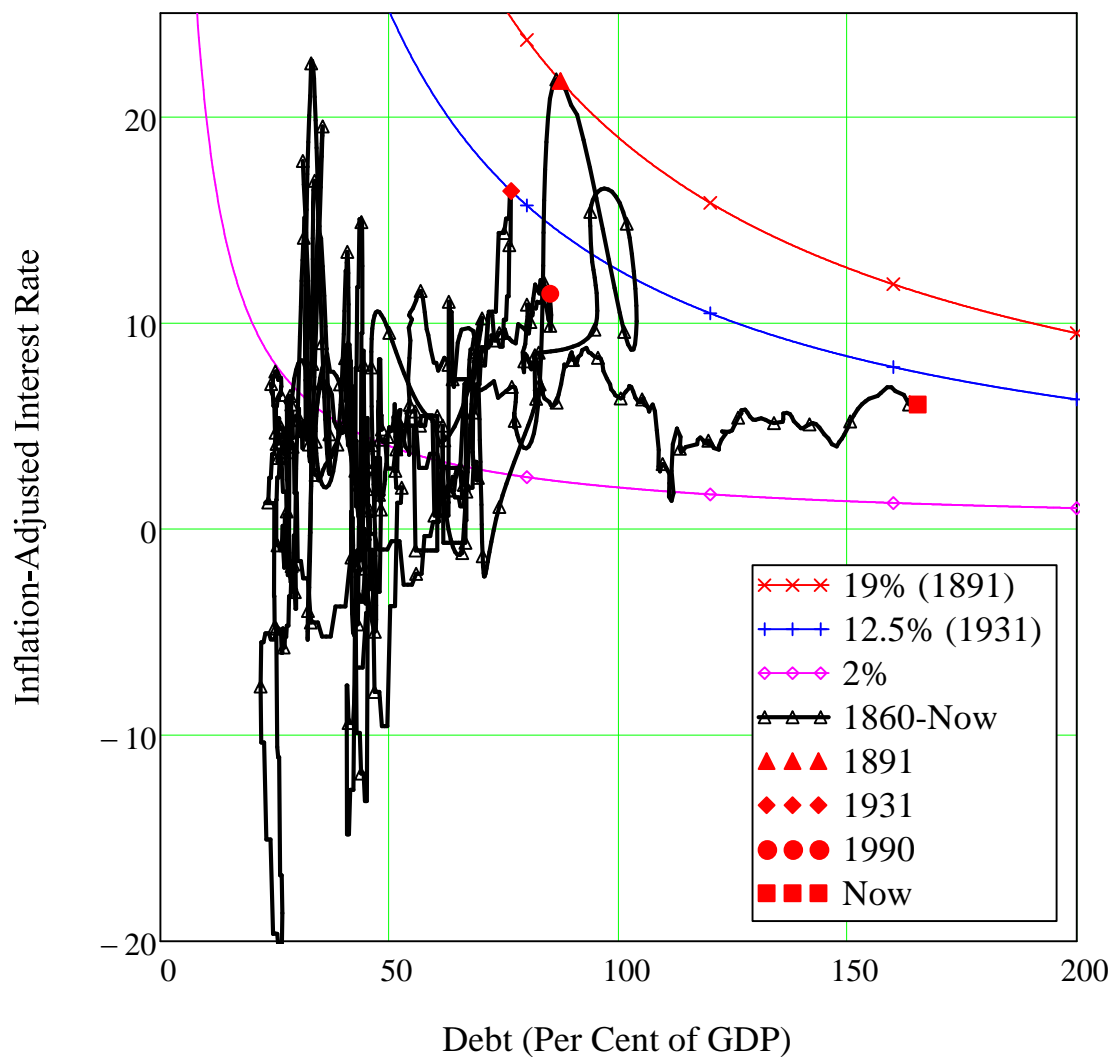
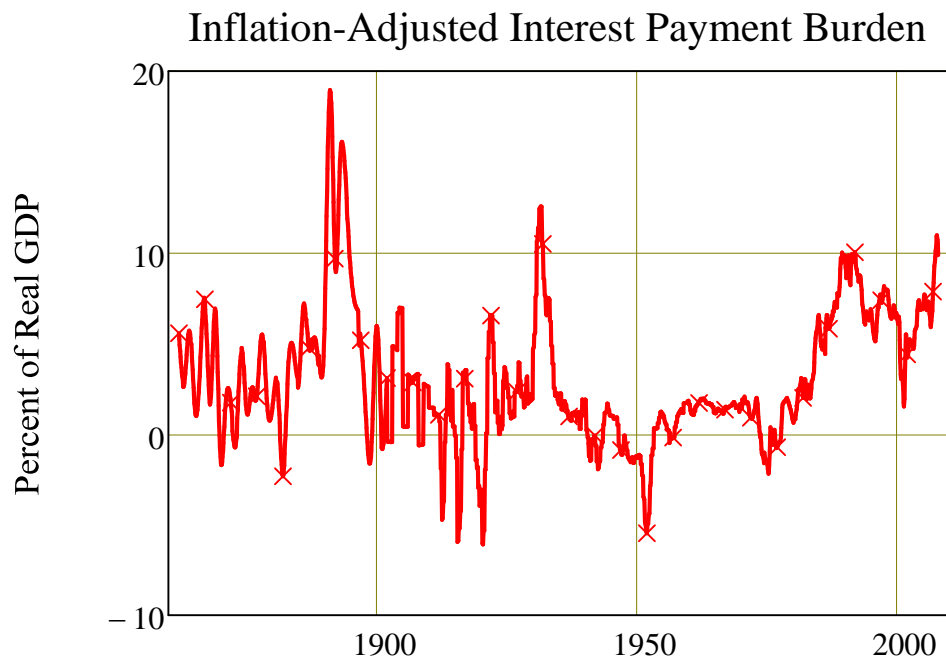


Figure 23

Inflation-Adjusted Interest Payment Burden

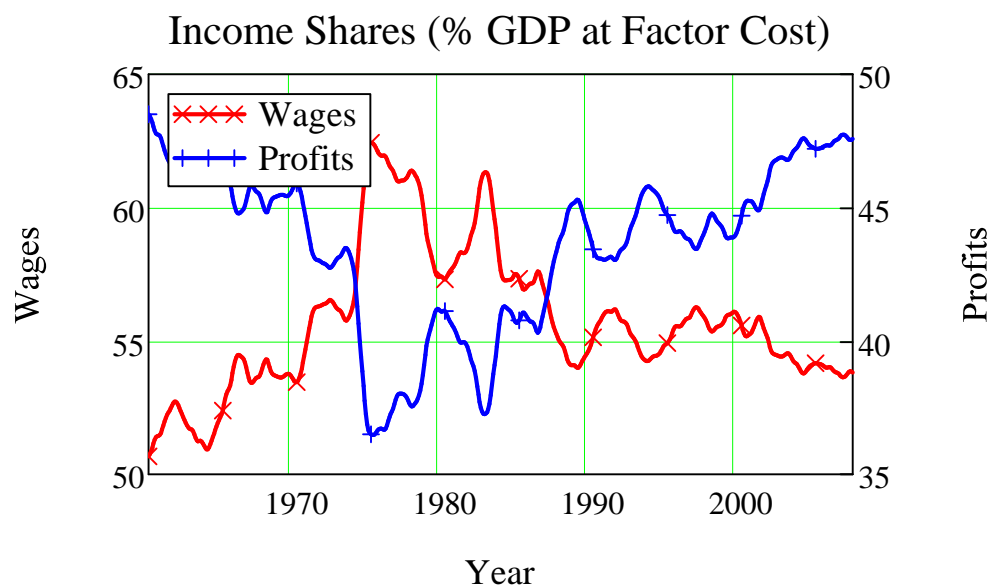




Income Shares



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.

Somewhat 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

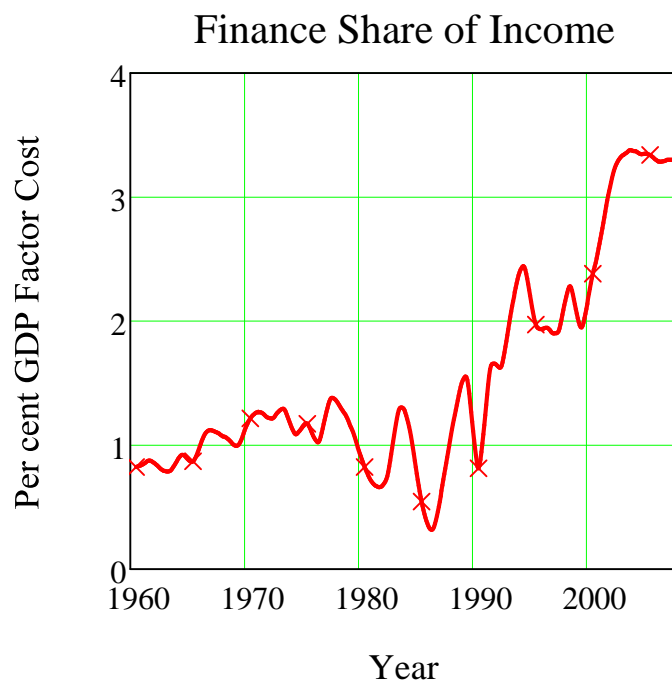
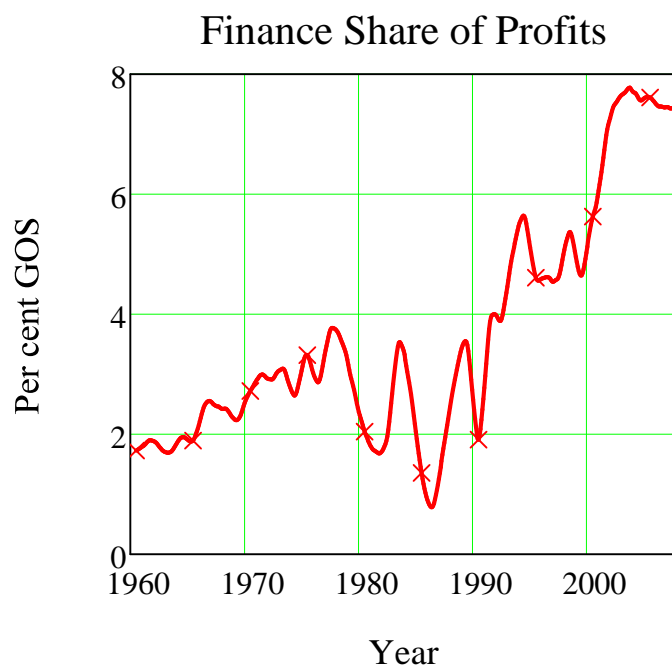


Figure 26



Debt contribution to Effective Demand

Figure 27



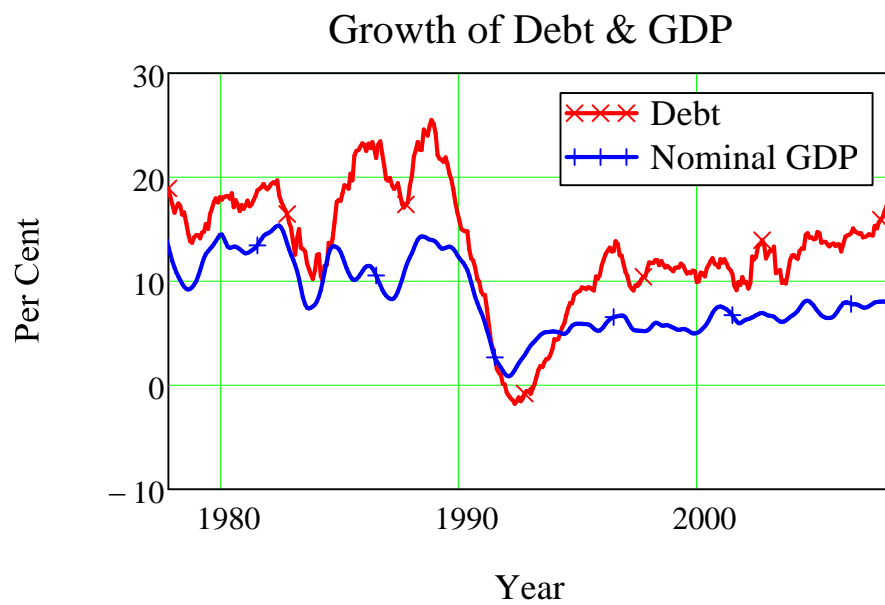


Figure 28

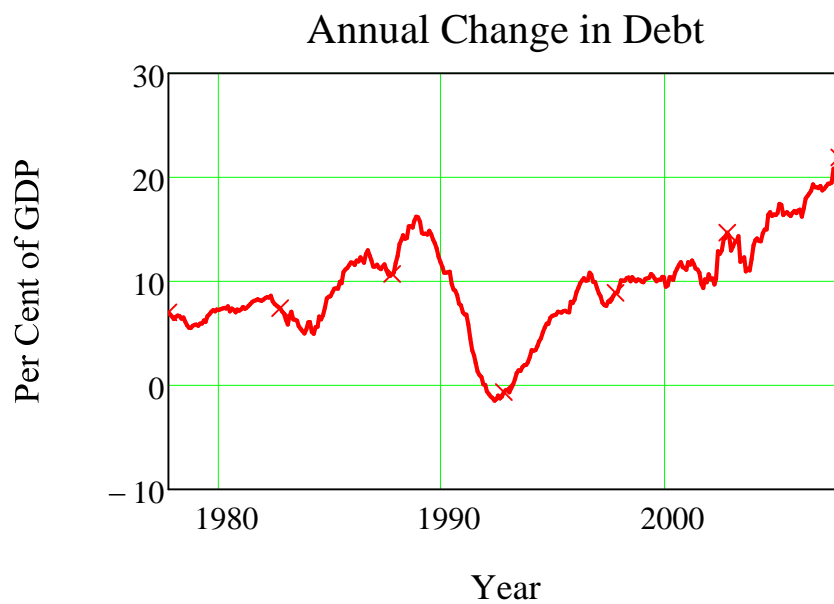


Figure 29

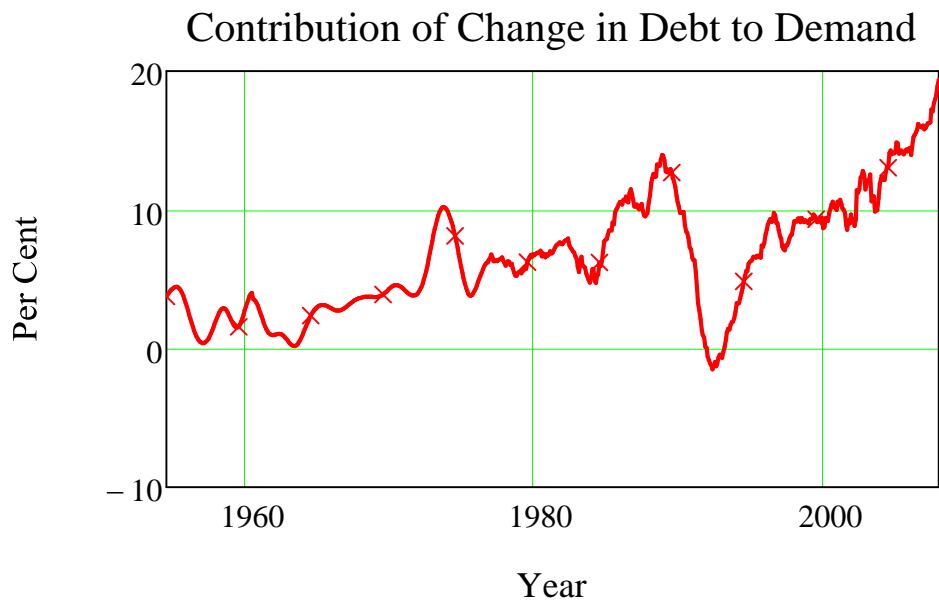
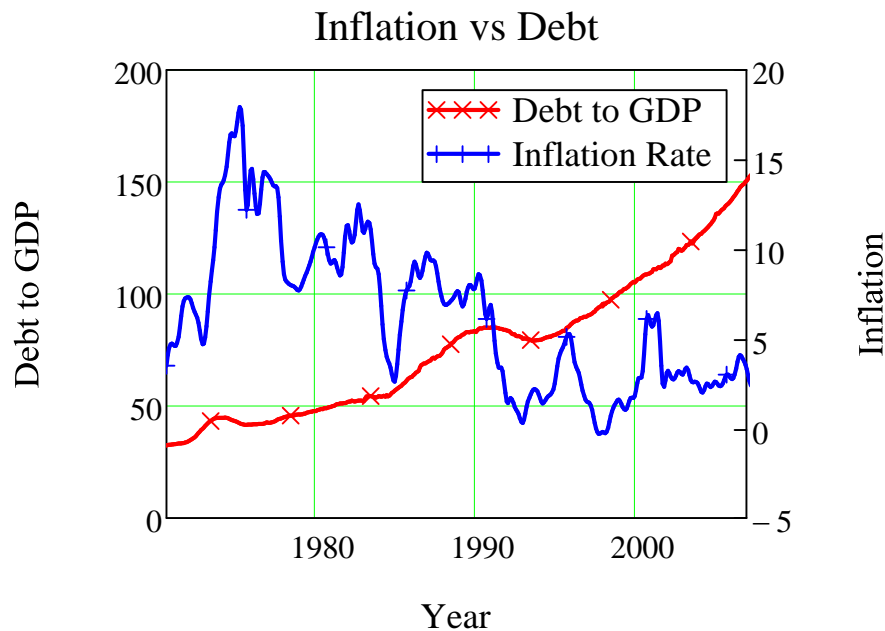


Figure 30



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

Monetary Aggregates

(The M1 series was affected by a substantial reclassification of assets in early 2002. I expect that the apparent downward trend in the debt to M1 ratio across 2001 can be ignored as a statistical anomaly, later corrected by the reclassification)

Figure 32

▶ Debt to Money

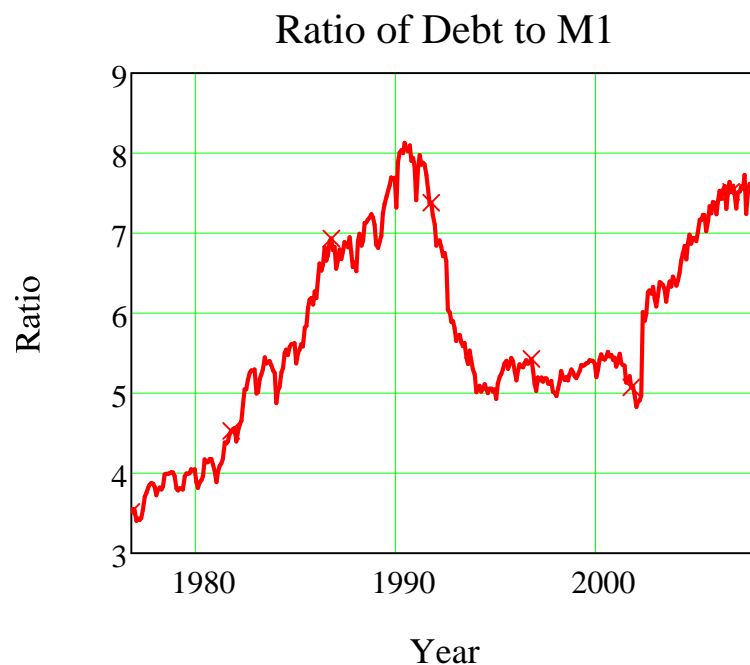
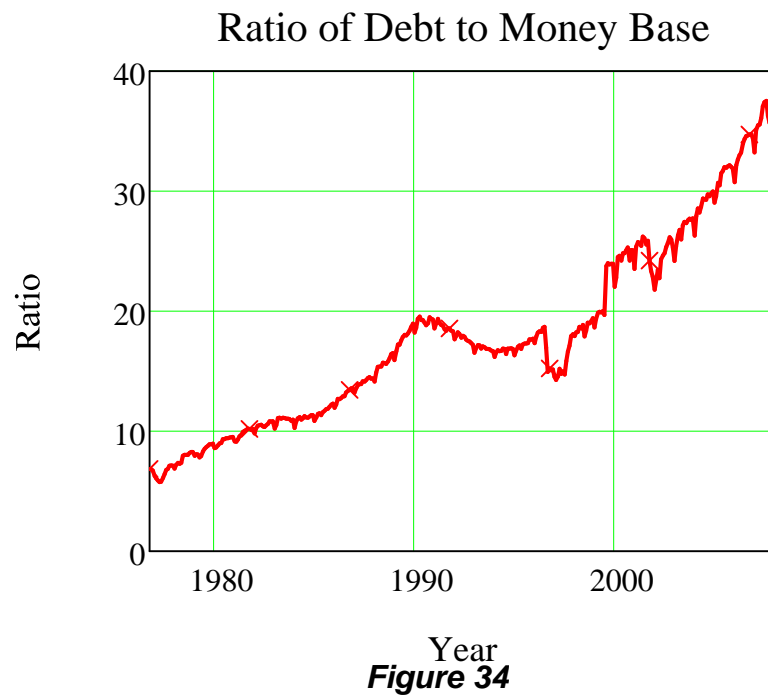


Figure 33

▶ Debt to Money

**Figure 34**

▶ Debt to Money

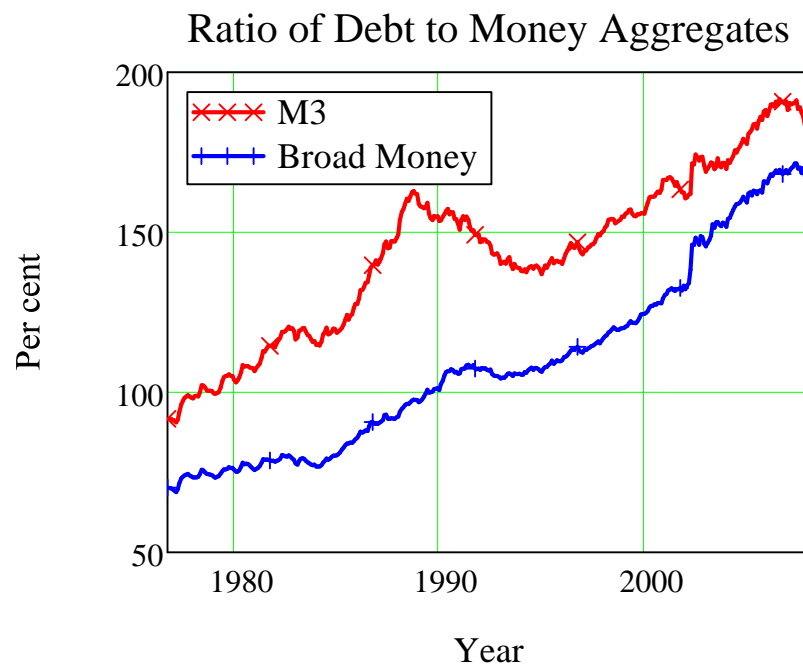
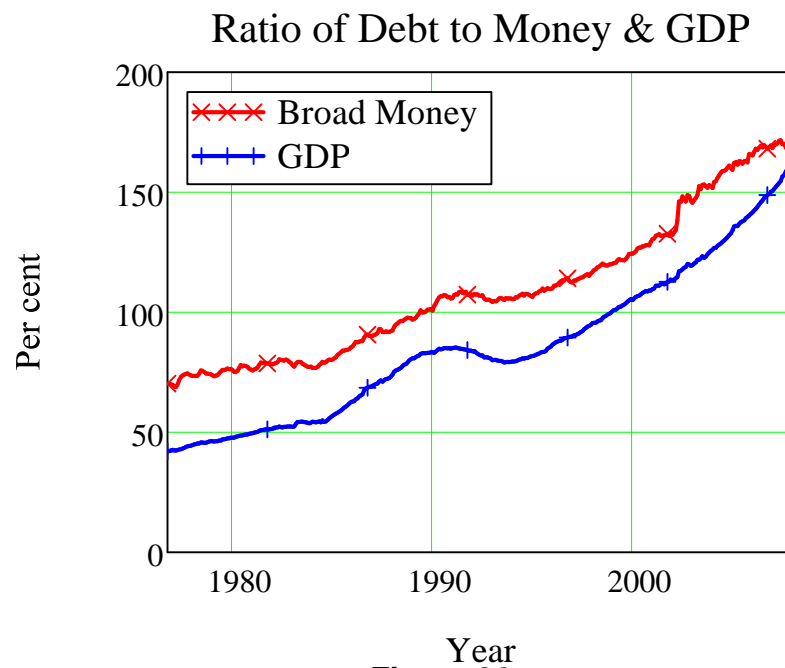


Figure 35

▶ Debt to Money

**Figure 36**

▶ Debt to Money

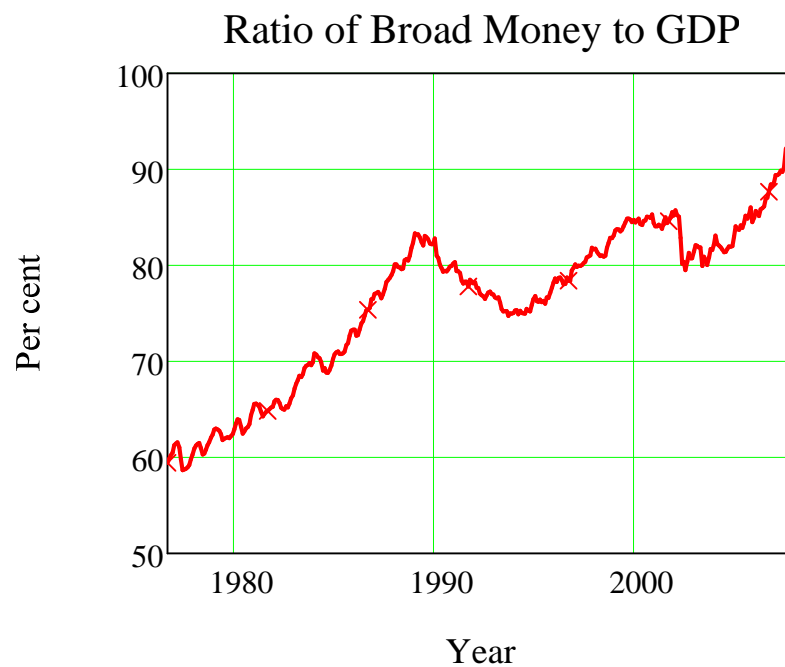
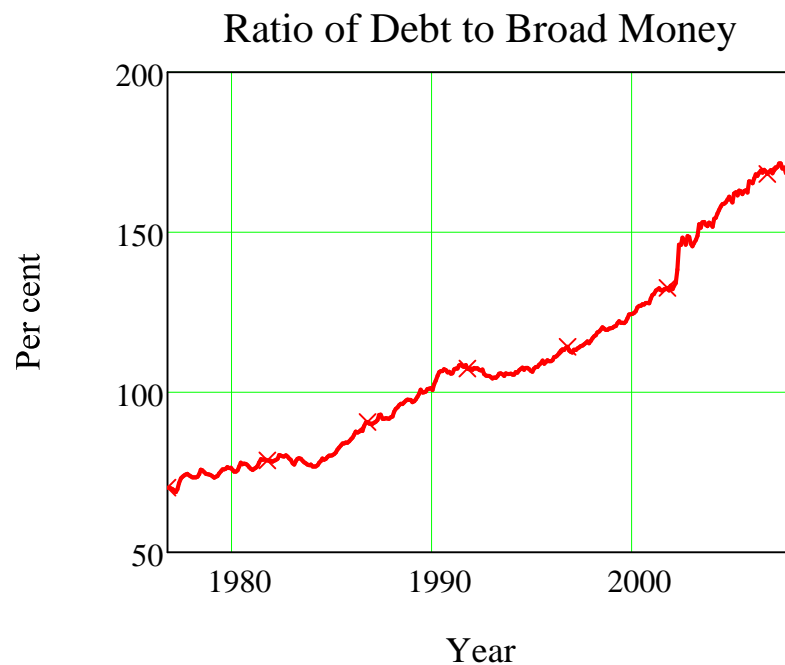


Figure 37

▶ Debt to Money



International Data

USA Data and USA-Australia Comparisons

Figure 38

▶ USA-Australia Household Debt Comparison

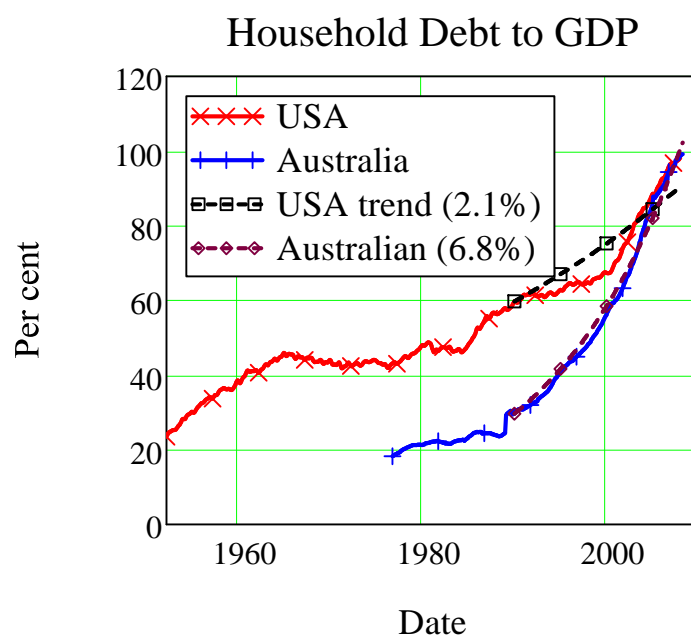
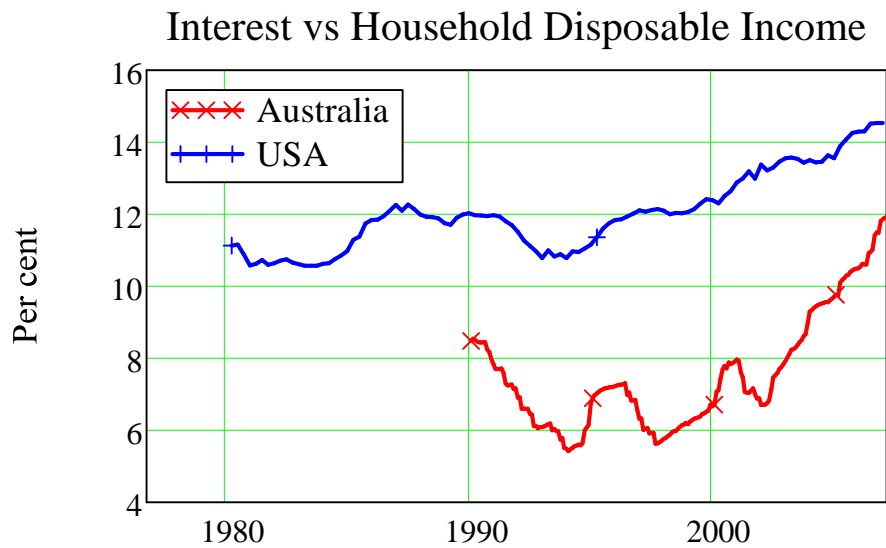
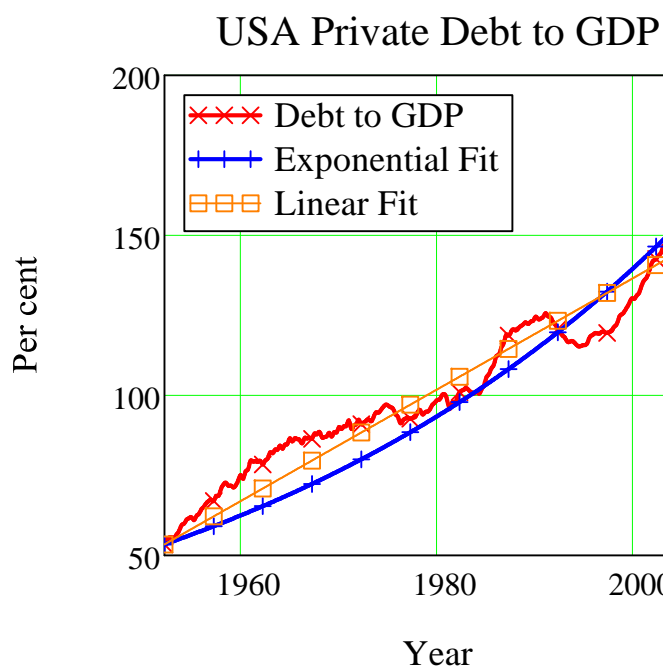
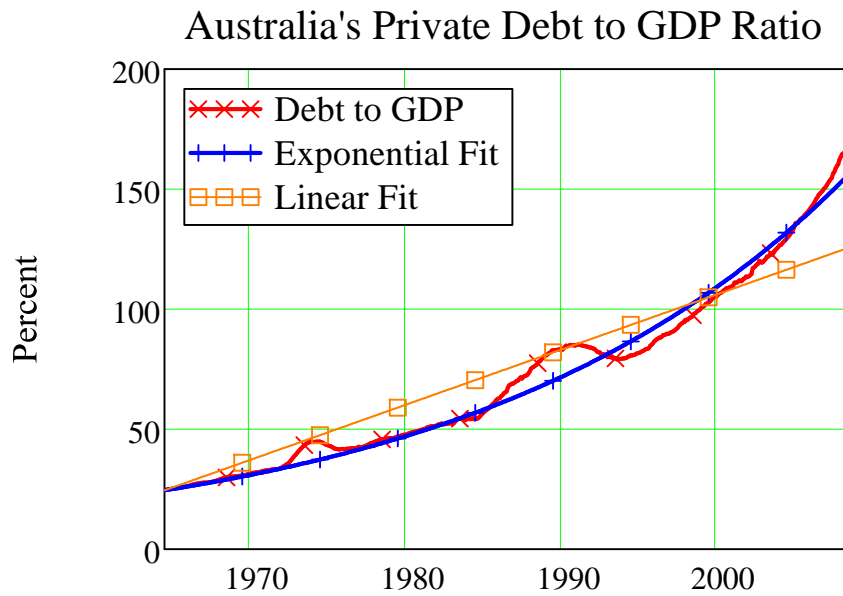


Figure 39**Figure 40**

▶ USA Private Debt to GDP



▶ Debt to GDP Regression



▢ OECD Composite Leading Indicators

Figure 41

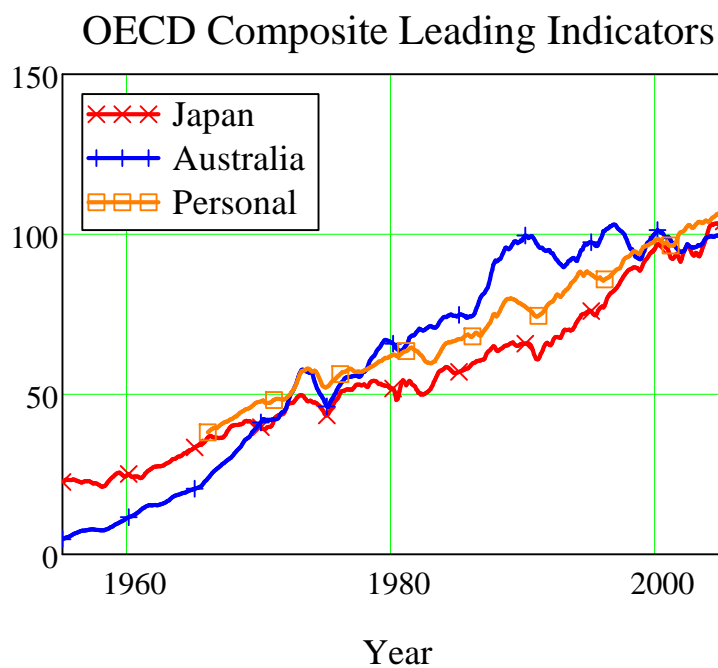
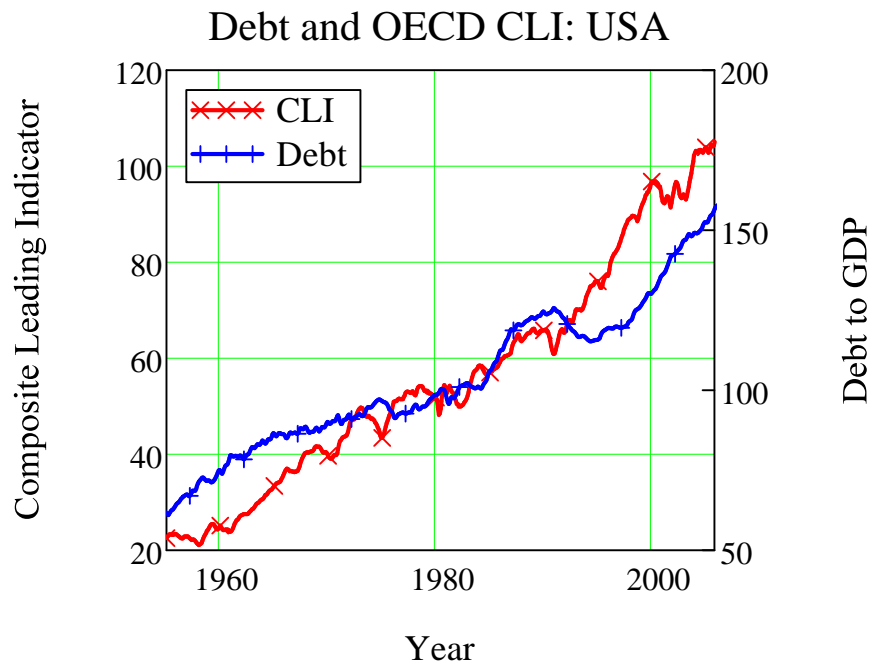
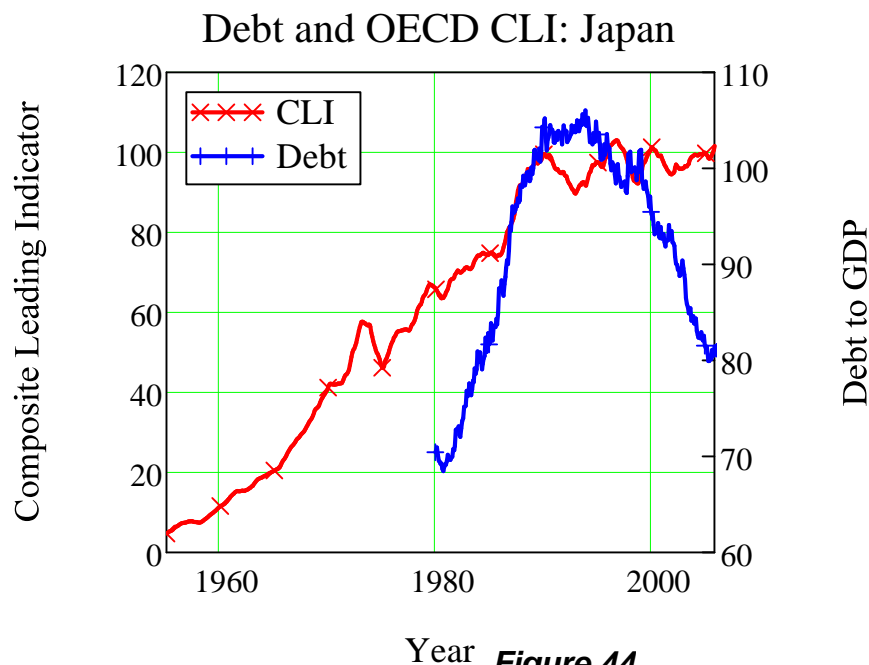
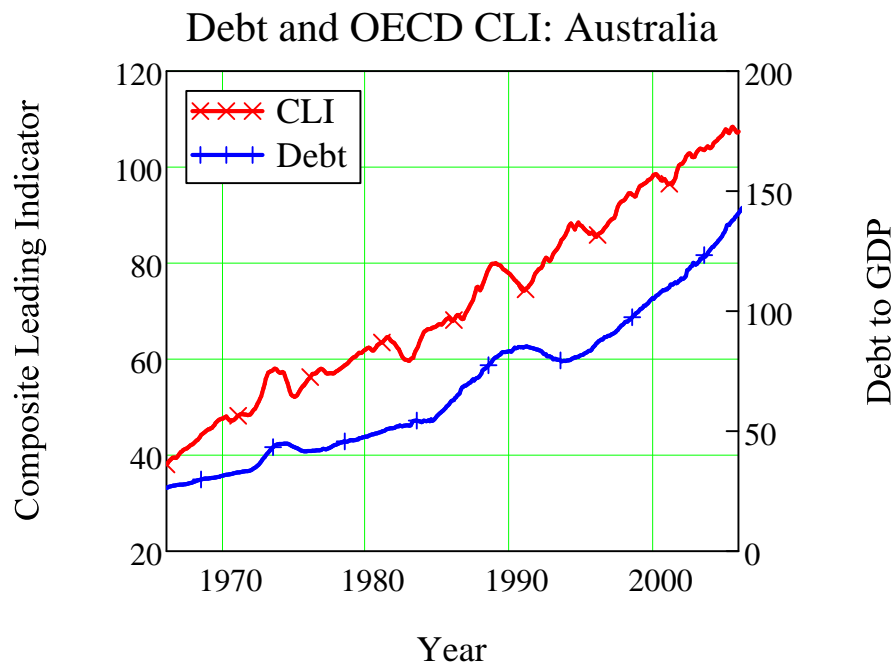


Figure 42

**Figure 43**

Japan was the last major economy to experience a debt deflation. Though I do not think the debt data here is comparable to that shown for the USA and Australia (which is sourced from their respective Central Banks), the role of debt in bringing the economy to a standstill is obvious from this chart. Equally obvious is how economically debilitating the process of reducing debt to income levels was--and also how necessary it was to be able to restore growth.

**Figure 44**

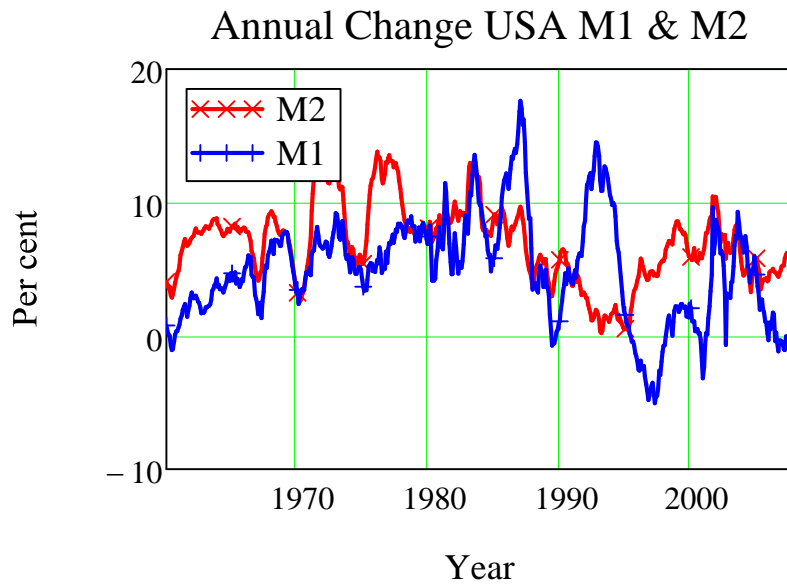
**Figure 45****USA Monetary Data**

▼ Change in USA Monetary Aggregates

$$\text{USAGE0}_{01} := \text{ToPercent}(\text{ChangePC}_{\text{Period}}(\text{USA}_{\text{M2_NSA}}, 12)) \quad \text{USAGE0}_{01}$$

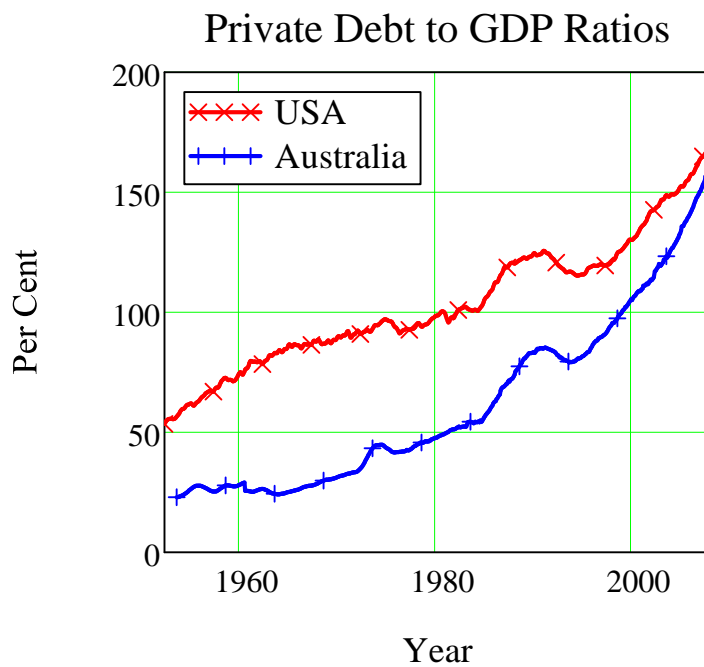
$$\text{USAGE0}_{02} := \text{ToPercent}(\text{ChangePC}_{\text{Period}}(\text{USA}_{\text{M1_NSA}}, 12)) \quad \text{USAGE0}_{02}$$

▲ Change in USA Monetary Aggregates



▶ USA & Aus Debt

Figure 46



☐ Exchange Rates: F11

$GI01_{01} := \text{ExRateUSA}$ $GI01_{02} := \text{ExRateJapanAus}$

$GI02_{01} := \text{ExRateTWL}$ $GI02_{02} := \text{ExRateSDRAus}$

$GI03_{01} := \text{ExRateUKA}$ $GI03_{02} := \text{ExRateNZAus}$

$GI04_{01} := \text{ExRateChin}$; $GI04_{02} := \text{ExRateHongKo}$; $GI04_{03} := \text{ExRateTaiw}$
 $\text{ExRateIndonesiaAus} := \text{DimData}(\text{F11}, 10)$
 $GI05_{01} := \text{ExRateIndor}$; $GI05_{02} := \text{ExRateMalaysi}$; $GI05_{03} := \text{ExRateSKoreaAu}$

Exchange Rates: F11

Figure 47

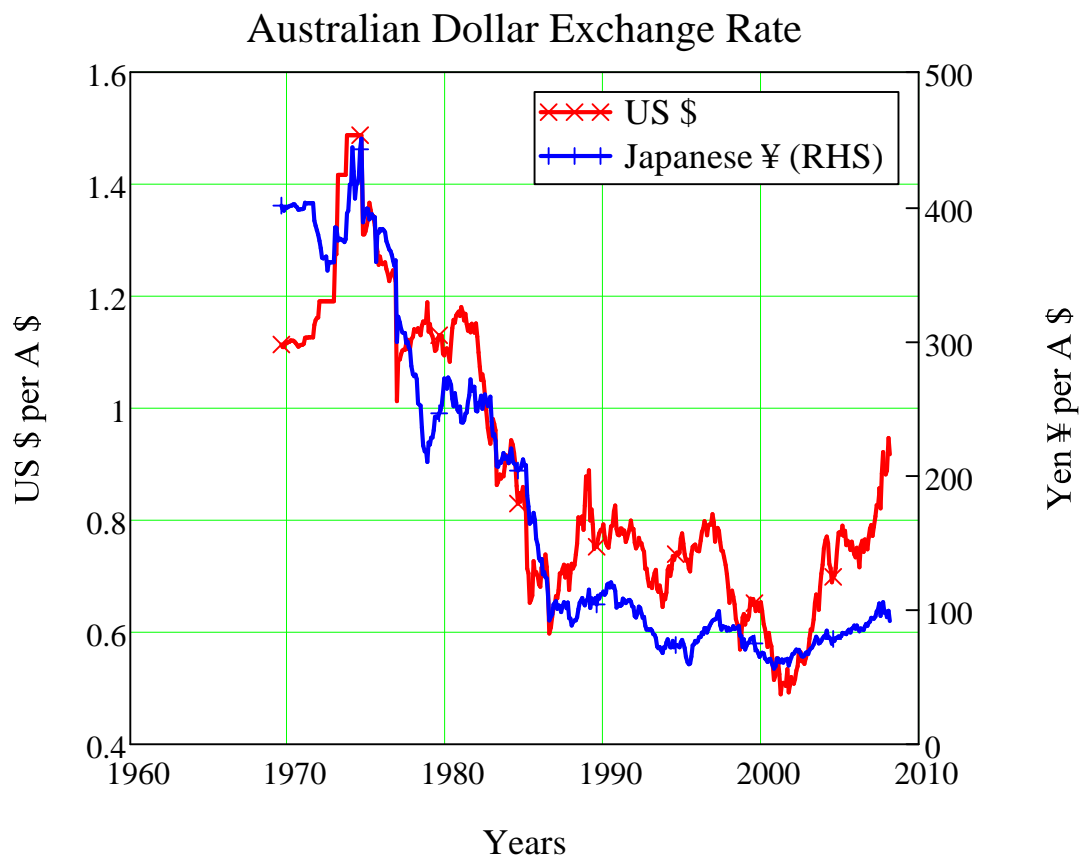
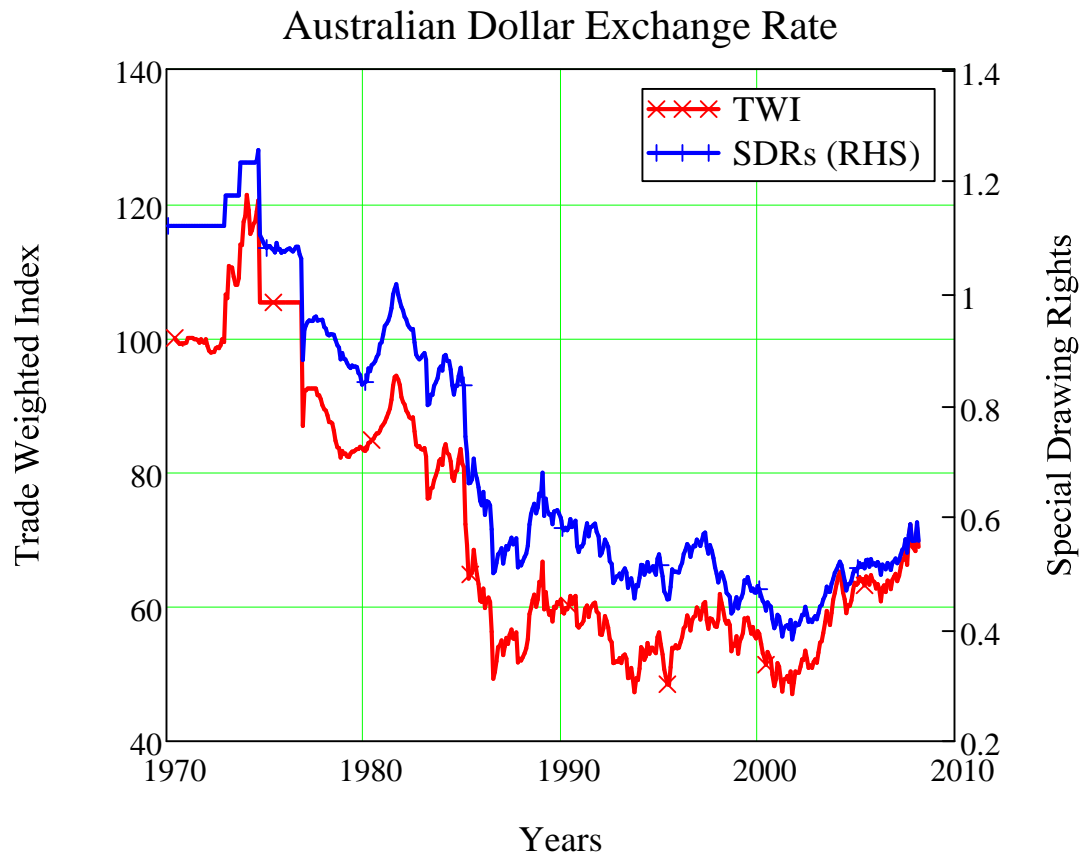
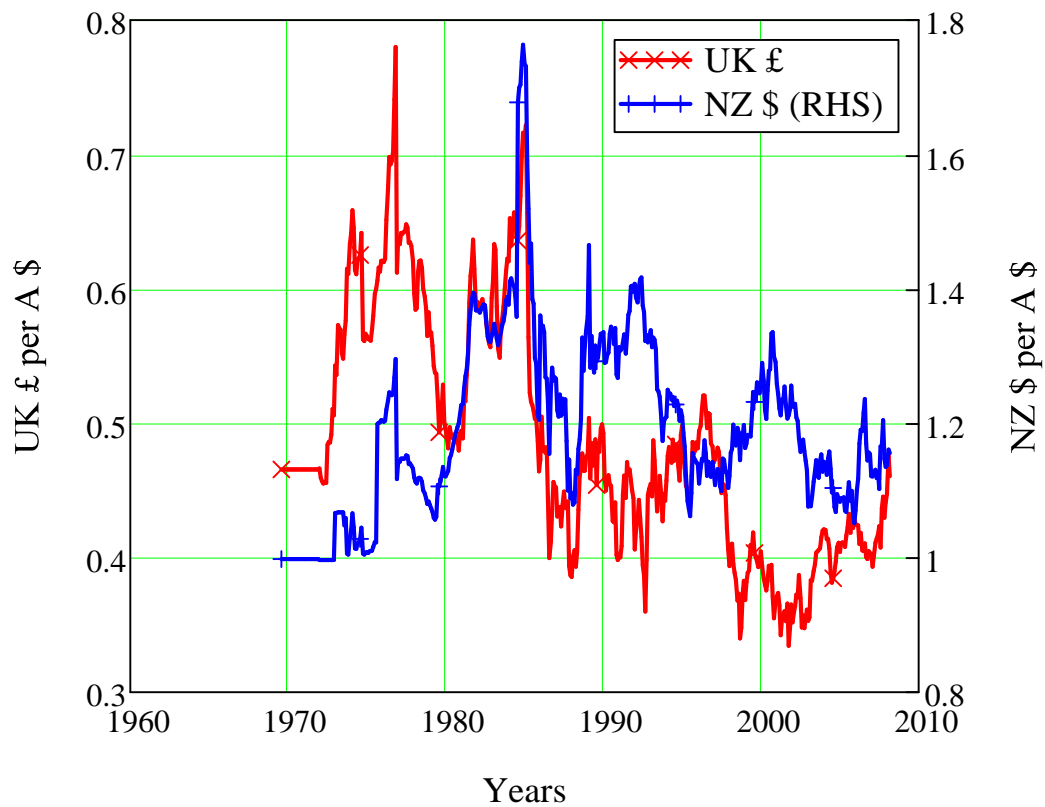


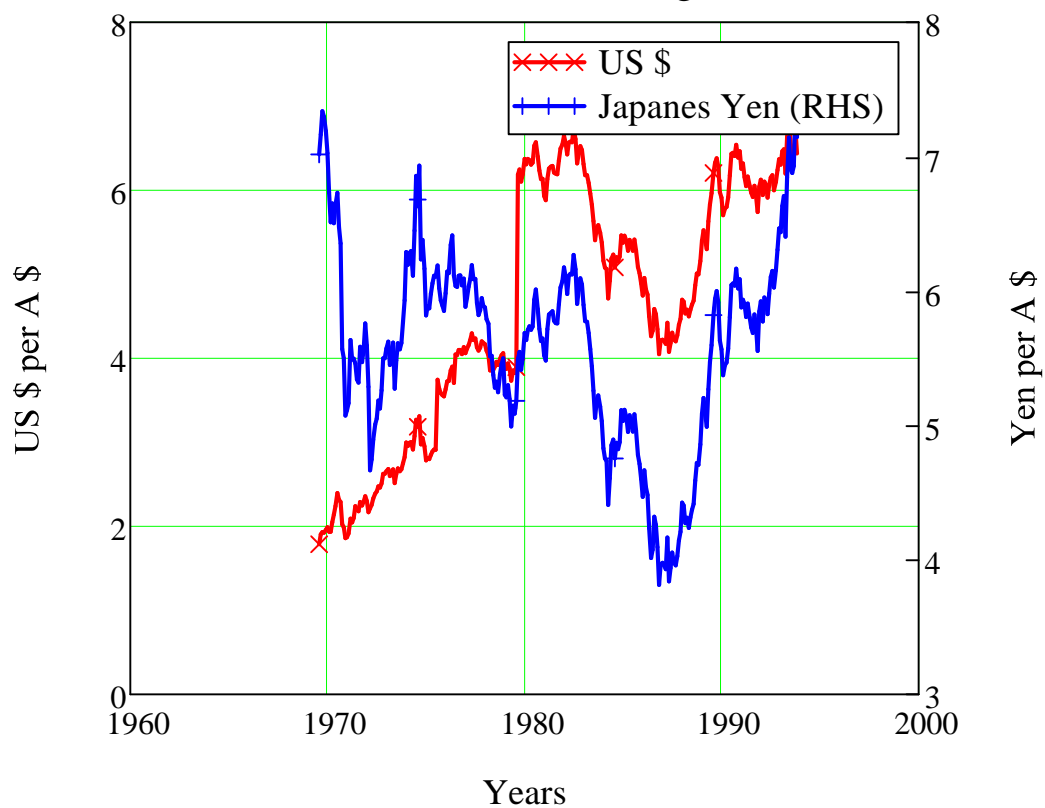
Figure 48



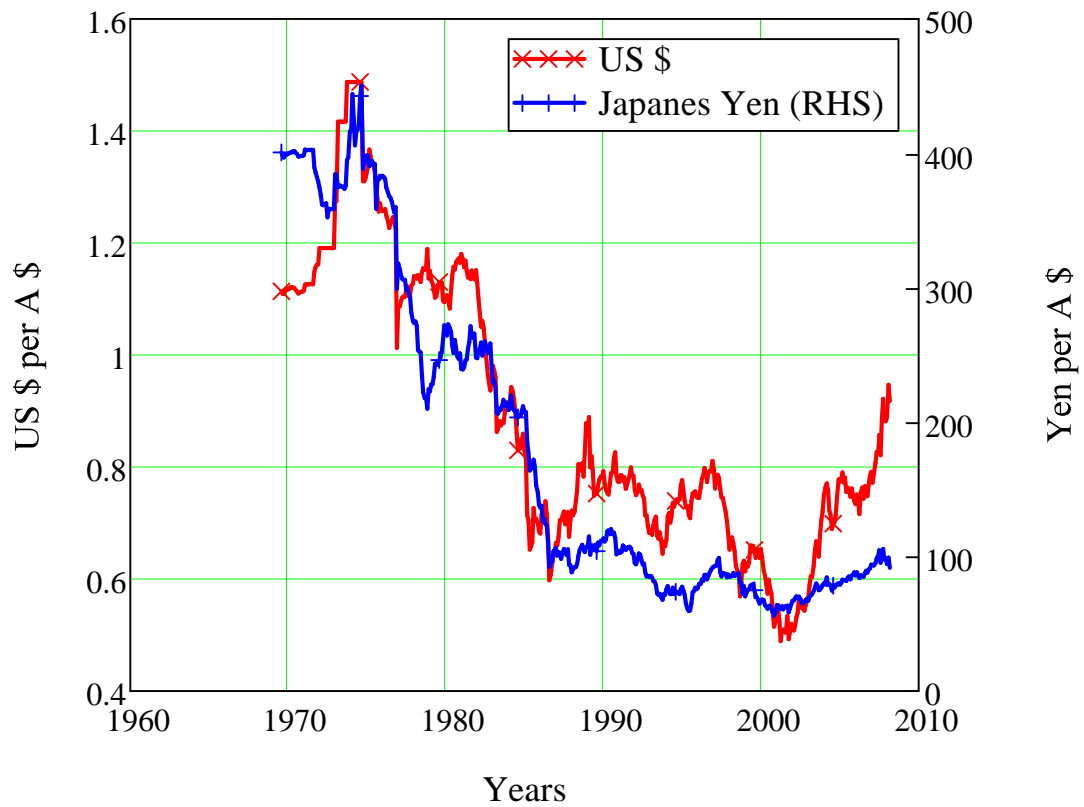
Australian Dollar Exchange Rate



Australian Dollar Exchange Rate



Australian Dollar Exchange Rate



Australian Dollar Exchange Rate

