

## Steve Keen's DebtWatch No 26 September 2008

### Losing control of the margin?

Late last year on SBS News, when Stan Grant asked me which way the RBA would move rates in 2008, I replied "Up, and then down", Stan quipped "Spoken like a true economist--an even handed answer!"--to which I replied "More down than up".

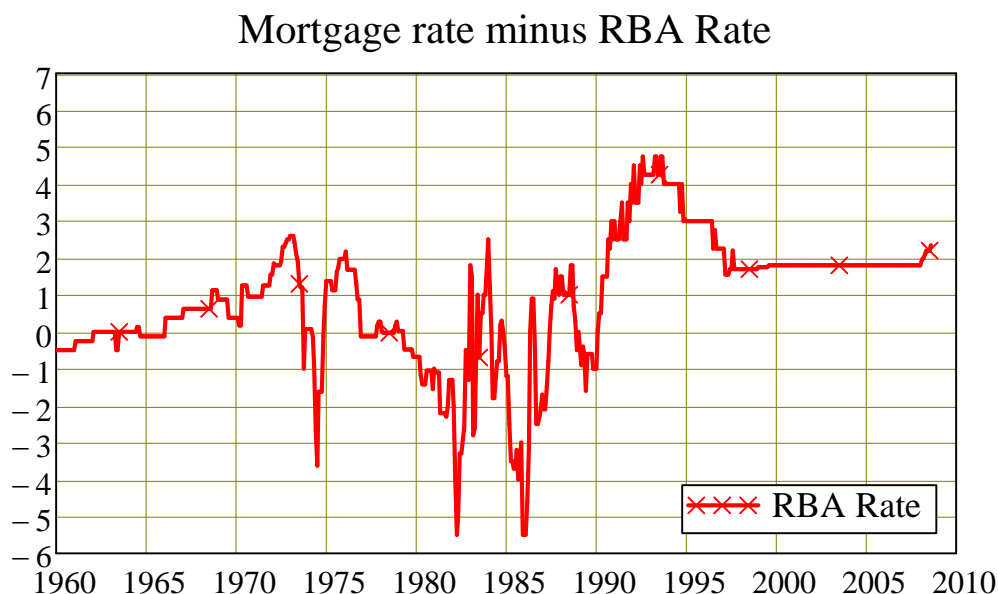
I expected the initial rate rises because of the RBA's focus on the rate of inflation, and a subsequent fall, not because inflation would be heading down, but because the economy would be--and the RBA rate would be forced to follow it

That day seems to be imminent, with the "surprise" 1% fall in retail sales, and the first signs of a tapering in credit demand as well. The RBA is now no longer focusing exclusively on inflation, but also on an apparently stalling economy. All market economists have now joined with me in expecting a rate cut this month--despite inflation still being above the RBA's target range.

Until last month's surprise announcement by the National Bank, it seemed that the only thing that wouldn't be heading down was the mortgage rate. Now, especially after Wizard's pre-emptive cut on Sunday, it's fairly certain that all lenders will pass on Tuesday's expected RBA cut. But there are good reasons why this is unlikely to be the case for subsequent cuts.

The idea that there is some stable relationship between the RBA rate and the mortgage rate is a furphy. When the RBA attempted to manage the economy by trying to control the money supply, the gap between the average mortgage rate and the RBA's overnight rate fluctuated wildly between *minus* 5.5 percent and plus 2.5 (see Figure 1).

Figure 1



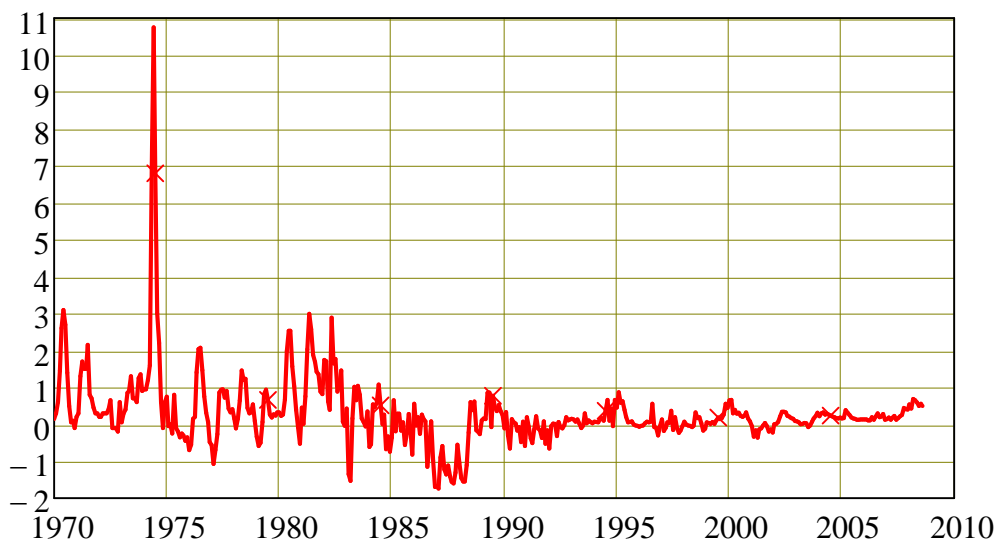
After the RBA abandoned targetting the money supply, and instead adopted a policy of trying to control short term interest rates, a stable relationship of sorts did develop. The gap settled down to about 4 percent, once the economy recovered from the 1990s recession.

This was roughly equal to the historical average gap between the rate banks charge for loans and the rate they offered for deposits--and banks, after all, make their money out of the spread between loan and deposit rates. Interest rate targetting "worked" because it controlled the banks'

costs of funds--as is evident from Figure 2, which shows that the 90 day bank bill rate has been very stable relative to the RBA rate since 1990 (though even this link is breaking down now--the margin between bank bill rates and the RBA rate is an indicator of how much banks trust each other, and they trust each other rather less now than in the recent past).

### Figure 2

#### 90 Day Bank Bill minus RBA Rate



The gap between mortgage and the RBA rate plunged from 4 percent in 1994 to 1.8 percent by mid 1997, as competition over market share broke out between banks and the new wave of non-bank securitised lenders.

It should now painfully obvious to everyone that this was not necessarily a good thing.

Those lower margins were driven primarily by lowering lending standards, rather than efficiencies, or the much-hyped wonders of competition. It therefore stands to reason that the margin will now rise, as the worst excesses of subprime and "low doc" lending are being driven from the market by the credit crunch.

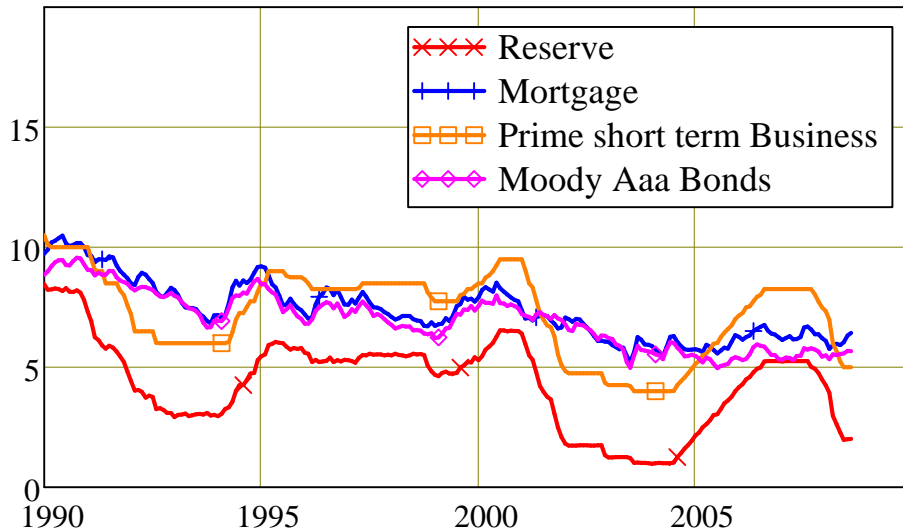
The margin has already risen to 2.35 percent, as banks have increased mortgage rates above and beyond the RBA's recent rate rises. But even that margin is still a long way short of the 4 percent gap that applied before lending standard plummeted with deregulation--and even of the 3 percent margin that applied at the time of the Wallis Committee.

The odds are that this margin will rise back to at least 3 percent, and possibly even 4 percent, as the RBA is forced to cut rates as the economy falls into recession. So the RBA may have to reduce its rate to 2 percent to ensure a mortgage rate of no more than 6 percent.

The RBA's dilemma is trivial compared to its US counterparts, however. US mortgage rates have *risen* in the last year, even though the Federal Reserve has reduced its rate from 5.25 to 2 percent (see Figures 3 and 4). The Federal Reserve has become almost impotent with respect to loan rates--and that impotency has got more extreme with time.

### Figure 3

### USA Reserve & Mortgage Rates



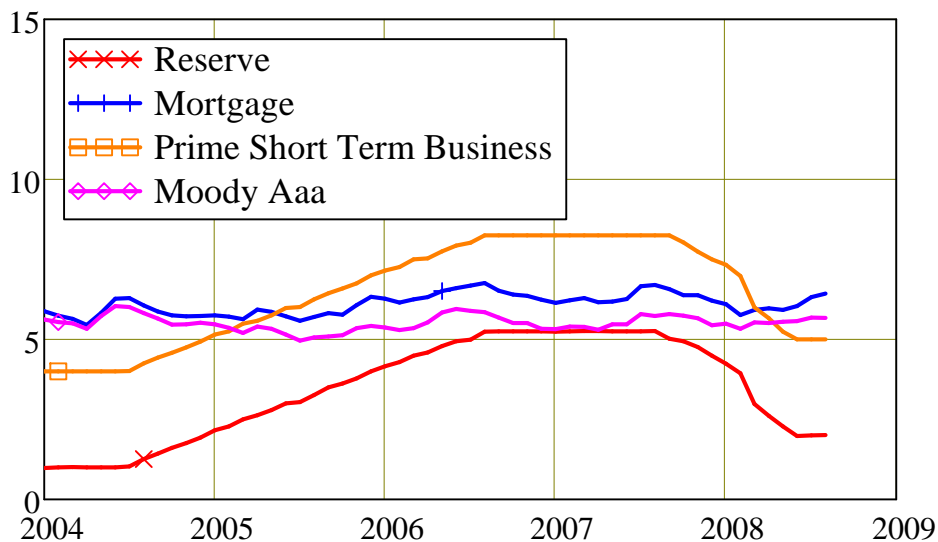
When the Fed cut its rate from 6.5% in 2001 to 1% in 2004, mortgage rates fell from 8.5% to 5.5%--so just over half of the rate cut was passed on to mortgagors. This time round, the Fed has cut its rate from 5.25% to 2%, only to see mortgage rates barely move--from 6.7% to 6.4%.

Much the same story applies to corporate borrowers. Aaa corporate bond rates now are the same as when the Federal Reserve rate was 3.5% higher. The US Fed can do something to restore the profitability of financial institutions--by increasing the gap between lending and borrowing rates--but it can do precious little to take the financial pressure off US householders and corporations.

The danger for banks of course, is that their long run profitability depends not just on the spread between loan and deposit rates, but on borrowers actually meeting their commitments. A profitable spread means nothing if your borrowers are sending you jingle mail rather than money.

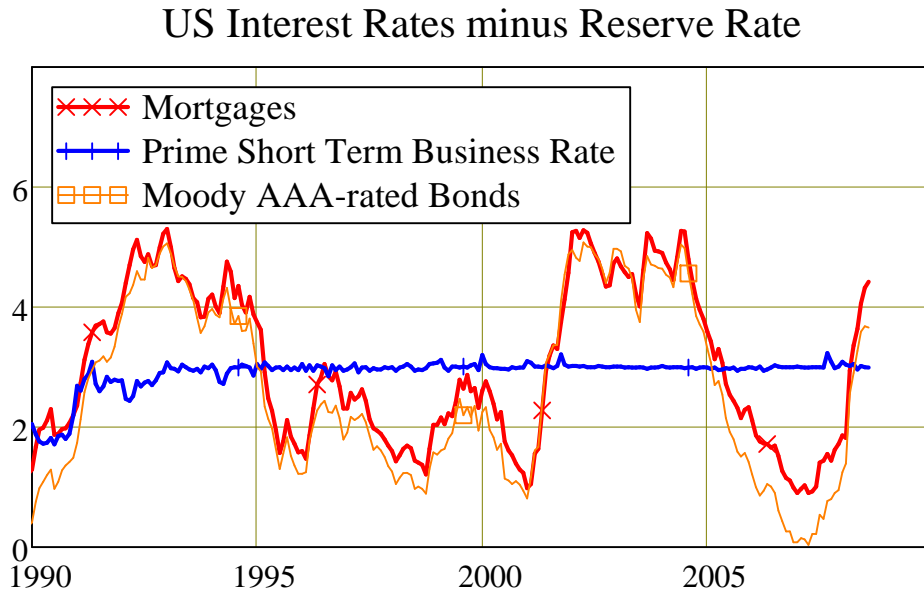
**Figure 4**

### USA Interest Rates--last 5 years



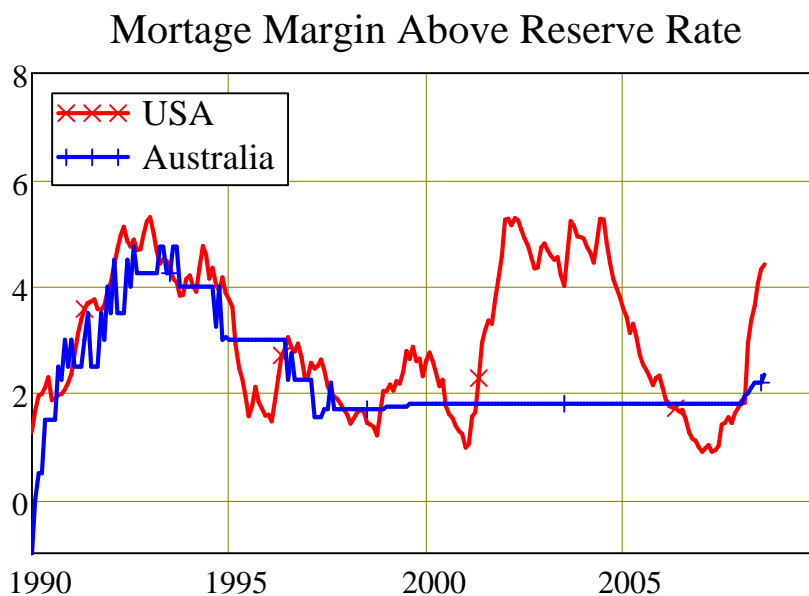
It thus appears that one other casualty of the Credit Crunch has been the capacity of Central Banks to manipulate the market interest rate. They can still control the short term rates--things like 90 Day Bank Bills here, and the Prime Short Term Business Rate in the USA (see Figure 5)--that set the banks' cost of funds. But they have lost their capacity to influence long term rates, the price that banks charge their lenders. The days of interest rate targetting by Central Banks may well be over.

**Figure 5**



The US Federal Reserve is starting to appreciate this, as official rate moves have done bigger all to reduce lending costs--in contrast to Australia's record, where mortgage rates have until recently closely tracked movements in official rates (see Figure 6).

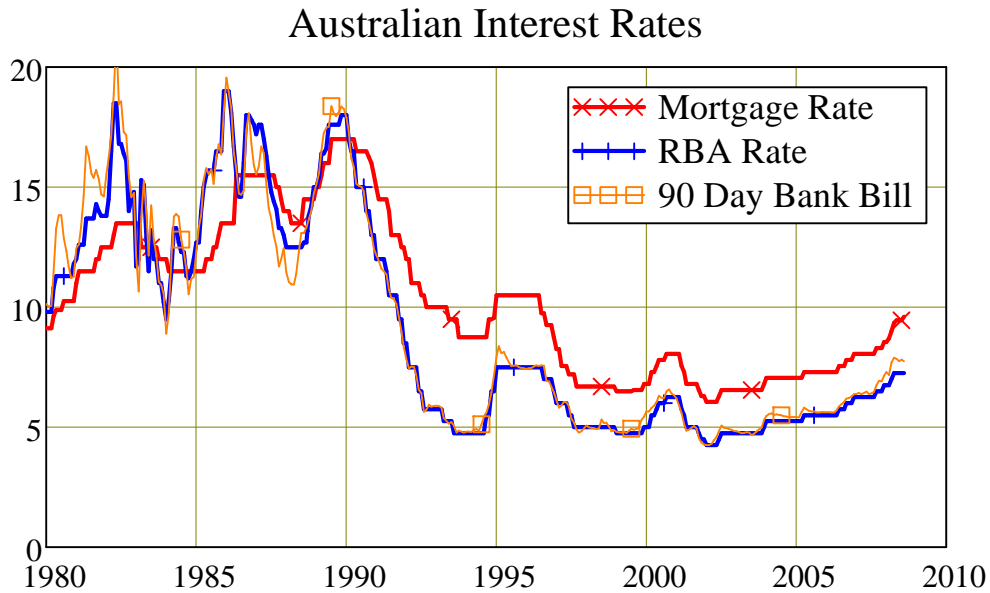
**Figure 6**



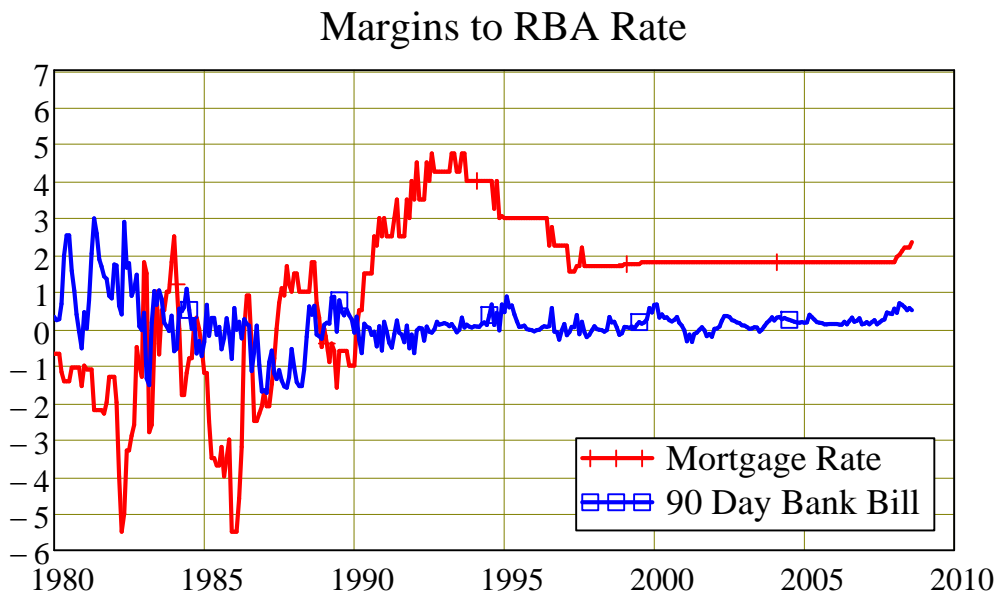
But after this month's compliance, lenders will start to use some of the future falls in the RBA

rate to restore their margins between loan and deposit rates. Imprudent lending drove the margin down to unsustainably low levels, and it has to rise in future to make responsible banking profitable once more.

**Figure 7**



**Figure 8**



**END OF COMMENTARY**  
**Comments on the Data**

The turnaround in credit growth seems to be underway. Though the monthly data is volatile, and subject to revision--last month's preliminary figures of credit growth have been revised upwards, from 5 billion to 22 billion--there is clear evidence of a break from decades of debt growing

faster than income, to debt growing more slowly than income.

Though this is necessary in the long term to wean Australia off its debt dependence, in the medium term it will cause a substantial slowdown in the economy--and it will push the economy into a deep recession.

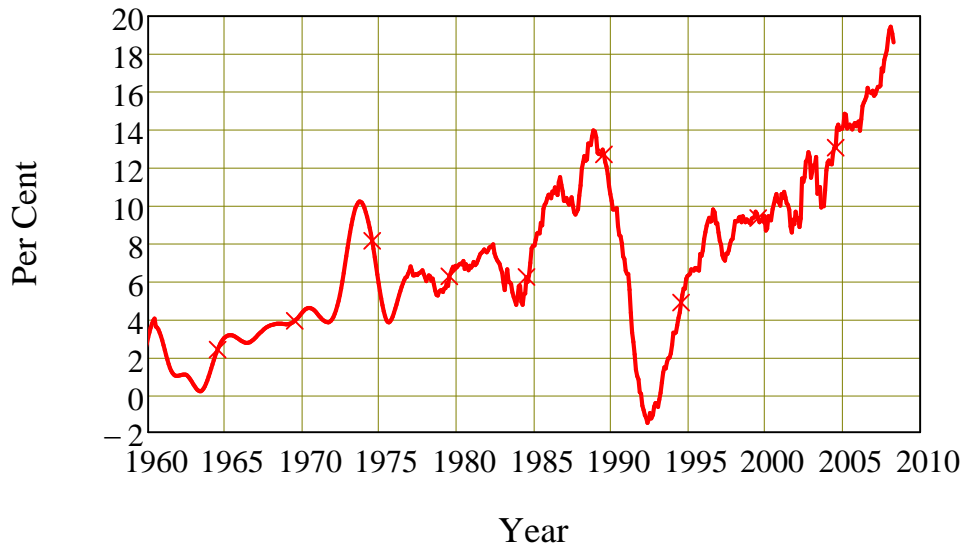


This is because aggregate demand is the sum of income plus change in debt. For the last decade, the latter factor has been adding to demand--and aggregate supply, asset prices, and our import bill have adjusted upwards to suit. But as the change in debt drops and ultimately turns negative, it will subtract from demand--and supply (read employment), asset prices and imports will follow it down.

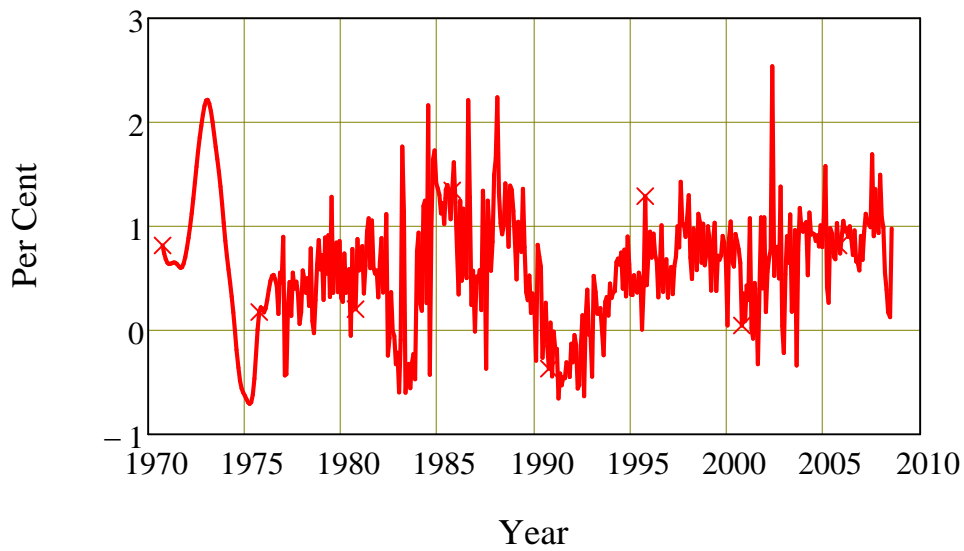
It seems probable that the Debt to GDP ratio will peak at about 166% of GDP. If Australians decided to reduce their debt to income ratio by 10% each year--to get back to the 25% level that applied back in the 1960s (before this long-term speculative bubble took off)--it would take roughly 15 years to get there.



### Contribution of Change in Debt to Demand



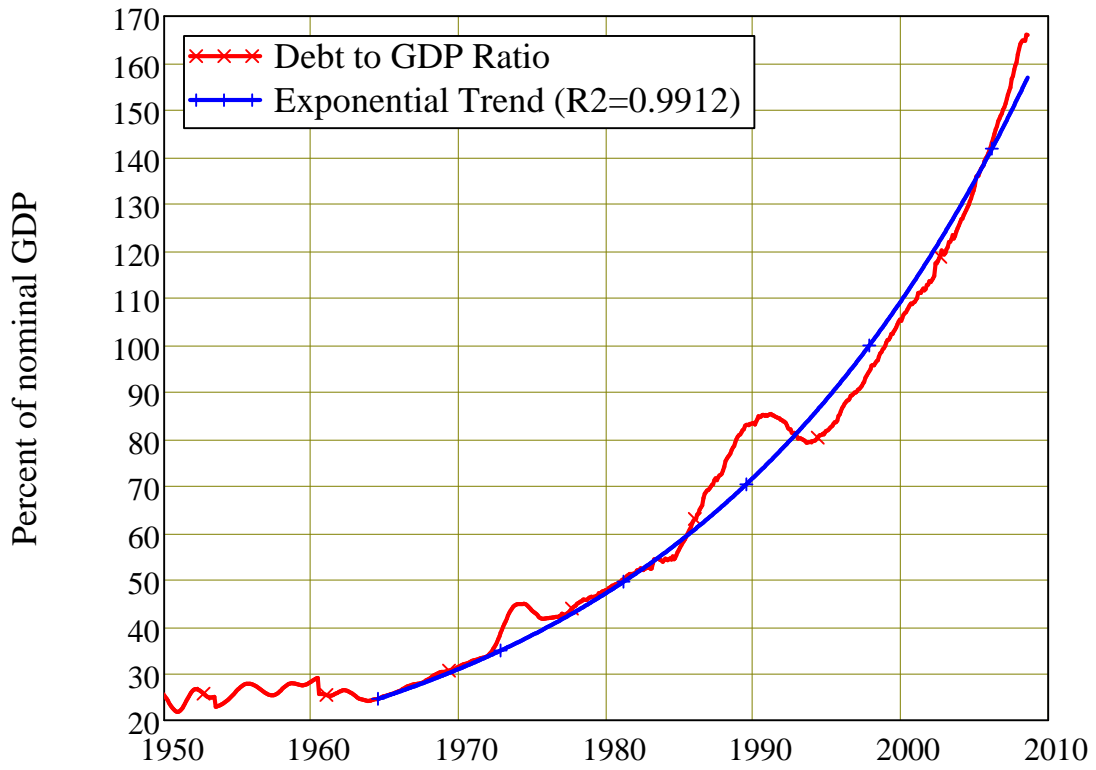
### CPI Deflated Monthly Change in Debt



**END OF COMMENTARY**

### Chart One

### The Debt Bubble



### Chart Two

Long Term



### Debt to GDP: The Long Term View

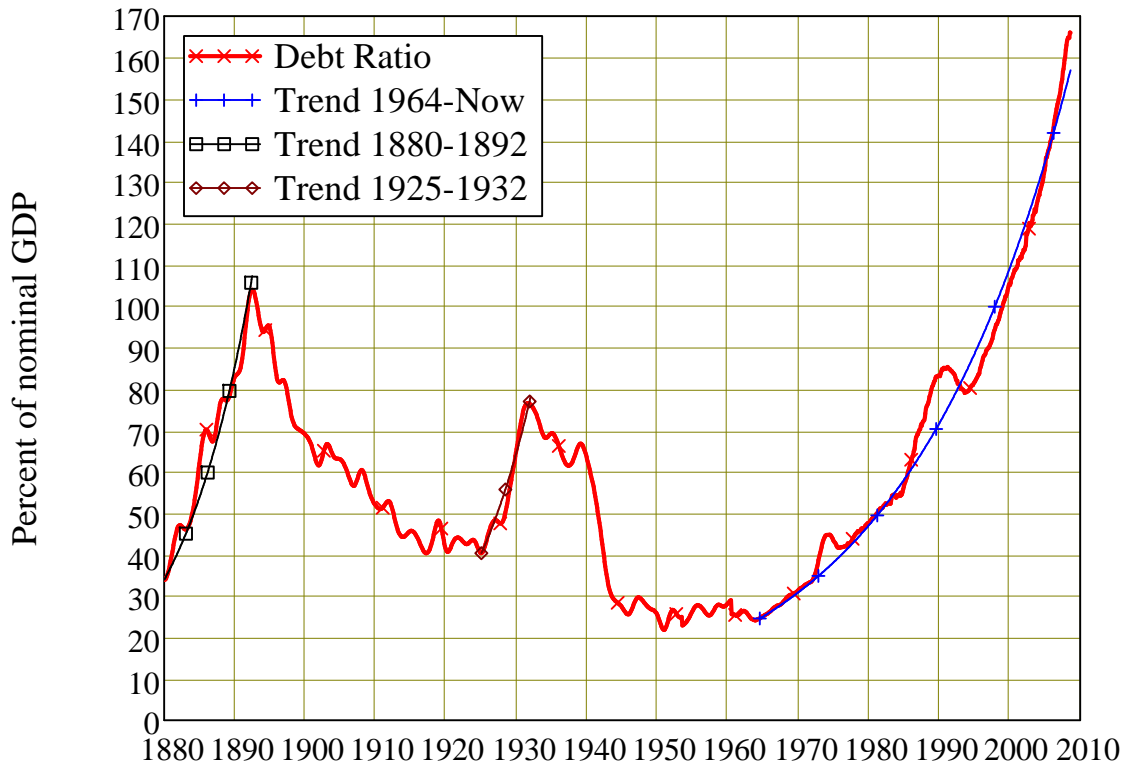


Table One: Aggregated Debt Summary

**Table One**

	0	1	2
0	"Summary"	"Total Private Debt"	"Nominal GDP"
1	"Date (levels)"	2008.58	2008.25
2	"Levels (\$m)"	1873700	1104983
3	"Change Month \$m"	8553	6218.14
4	"Change Month %"	0.46	0.57
5	"Change Year \$m"	220289	81470
6	"Change Year %"	13.32	7.96
7	"Since 1990"	8.84	5.47
8	"Since 1980"	12.01	7.9
9	"Since 1964"	13.47	9.36
10	"Date (% GDP)"	2008.58	"N/A"
11	"As % of GDP"	165.95	100
12	"Change Month"	-0.07	"N/A"
13	"Change Year"	5.53	"N/A"
14	"Since 1990"	3.07	"N/A"
15	"Since 1980"	4.14	"N/A"
16	"Since 1964"	4.19	"N/A"

D<sub>1</sub> =

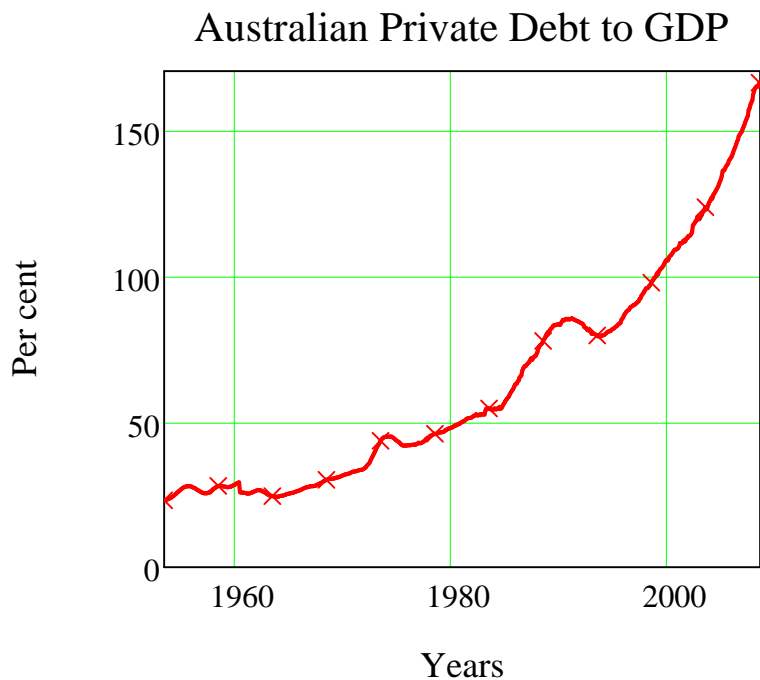
Table Two: Disaggregated Debt Summary

**Table Two**

	0	1	2	3
0	"Detail"	"Business"	"Mortgage"	"Personal"
1	"Levels (\$m)"	749382	969100	153809
2	"Change Mth \$m"	1661	5188	-2168
3	"Change Mth %"	0.22	0.54	-1.39
4	"Change Yr \$m"	125085	90313.35	5767
5	"Change Yr %"	20.04	10.28	3.9
$D_2 =$ 6	"Since 1990"	5.38	14.86	5.74
7	"Since 1980"	10.68	14	10.44
8	"Since 1976"	11.2	14.27	11.2
9	"As % of GDP"	66.41	85.88	13.63
10	"Change month"	-0.29	0.03	-1.89
11	"Change year"	11.83	2.74	-3.2
12	"Since 1990"	-0.52	9.33	-0.2
13	"Since 1980"	3.03	6.05	2.63
14	"Since 1976"	3.1	5.83	3

**Debt to Income Ratios**

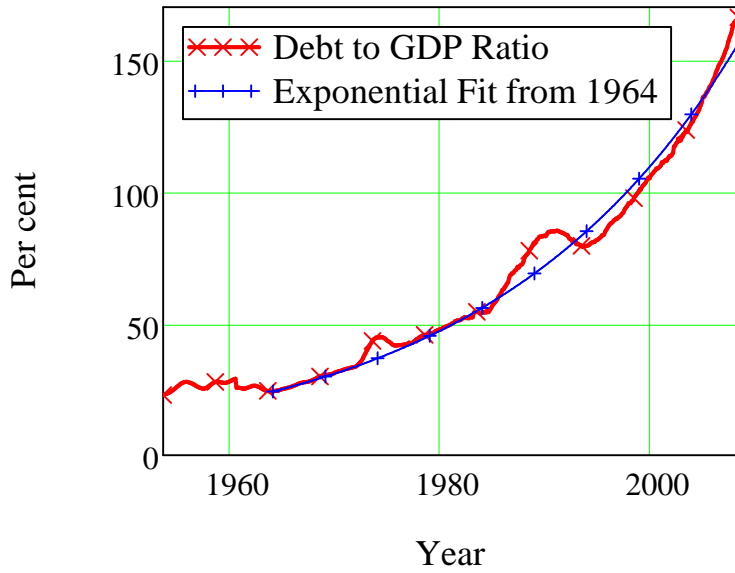
▣ Debt to GDP (D02 &amp; G12)

**Figure 1**

▣ Debt to GDP Regression

**Figure 2**

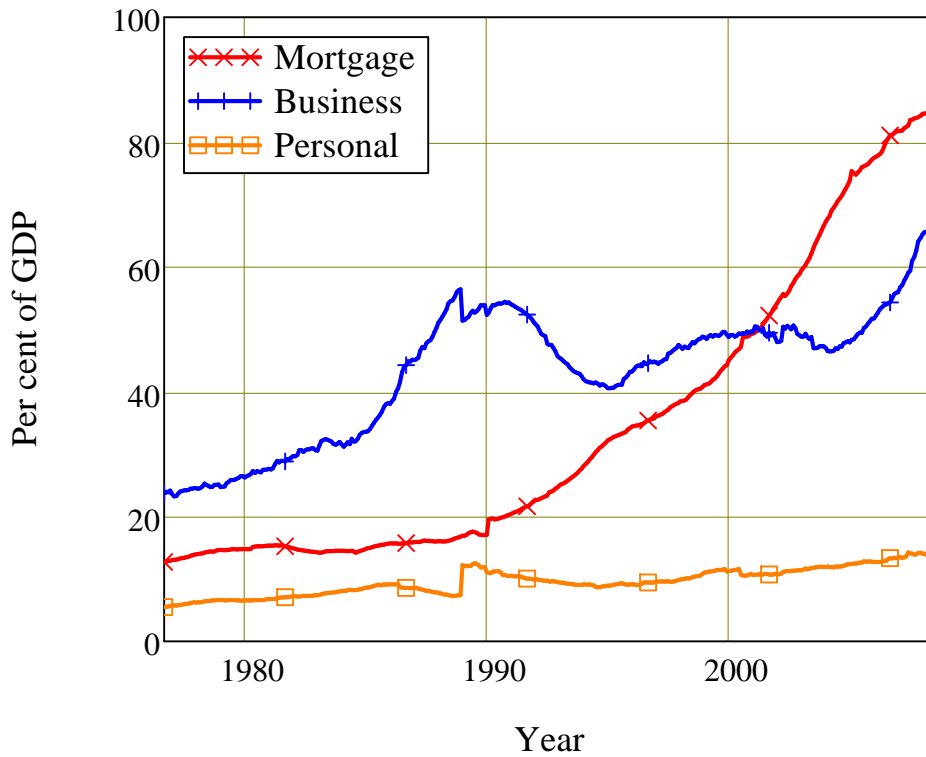
### Australian Private Debt to GDP



▢ Debt Components to GDP

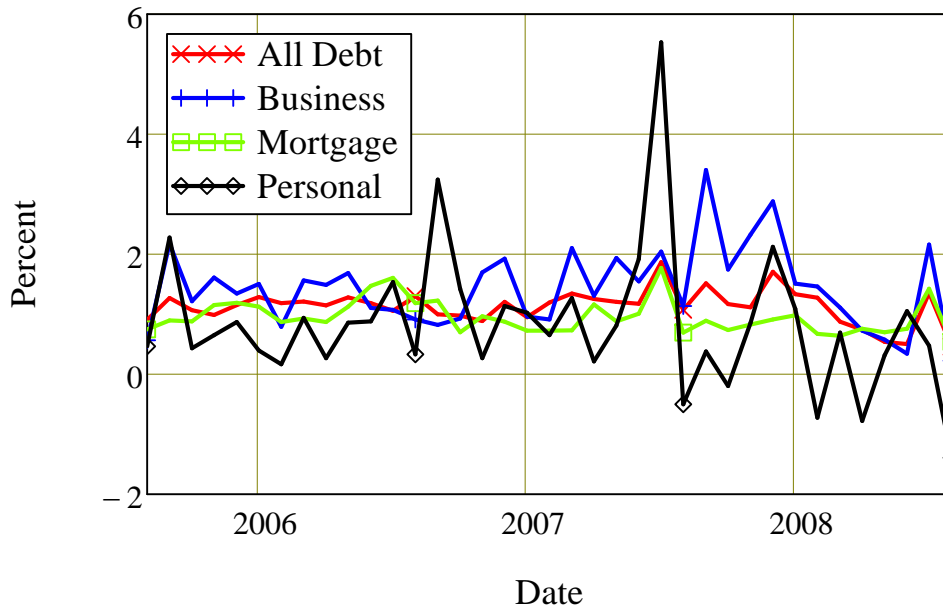
**Figure 3**

### Components of Australian Debt



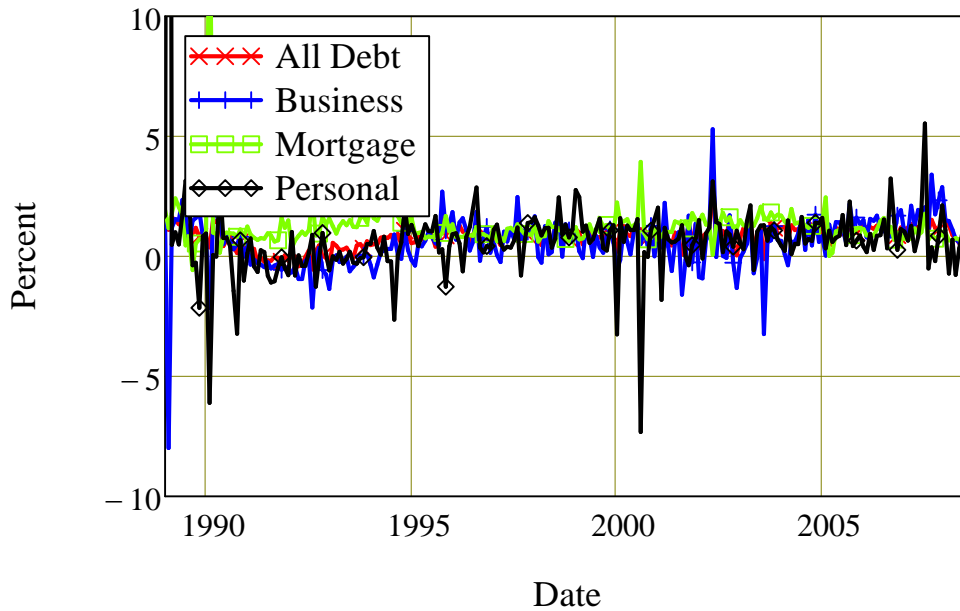
▢ Monthly Growth Rates

### Debt Monthly Growth Rates--Last 3 Years



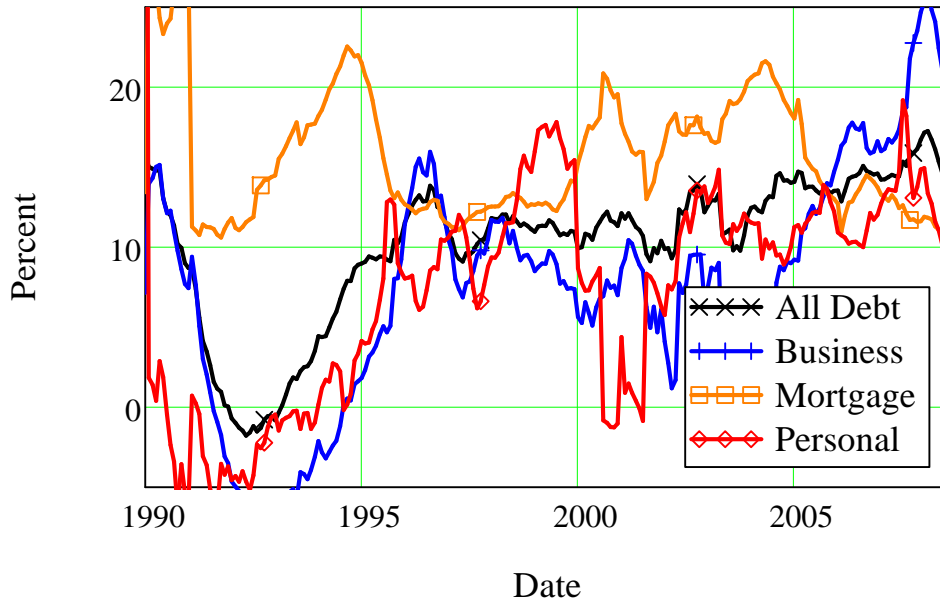
▶ Monthly Growth Rates

### Debt Monthly Growth Rates



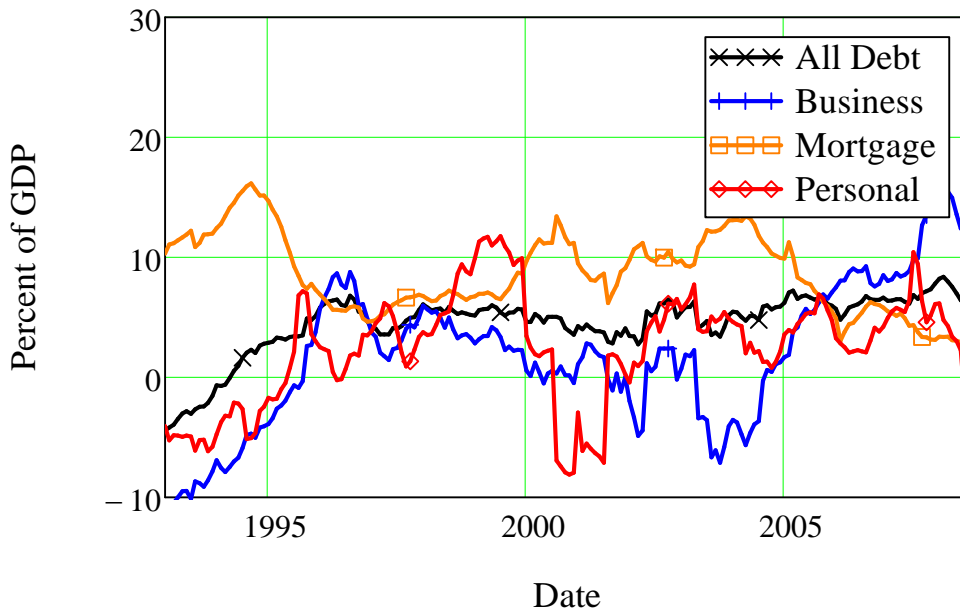
▶ Yearly Growth Rates

### Debt Yearly Growth Rates



▢ Ratios Yearly Growth Rates

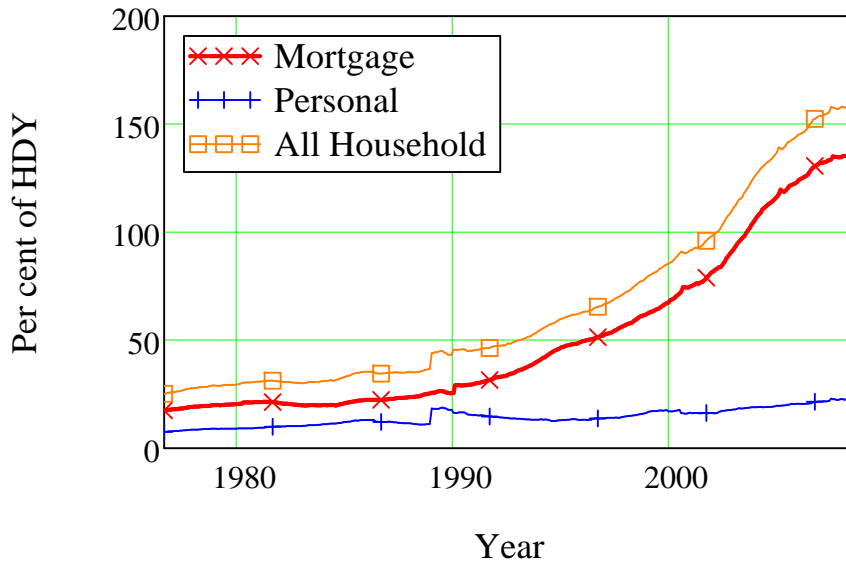
### Debt Ratios Yearly Growth Rates



▢ Debt to Household Disposable Income

**Figure 4**

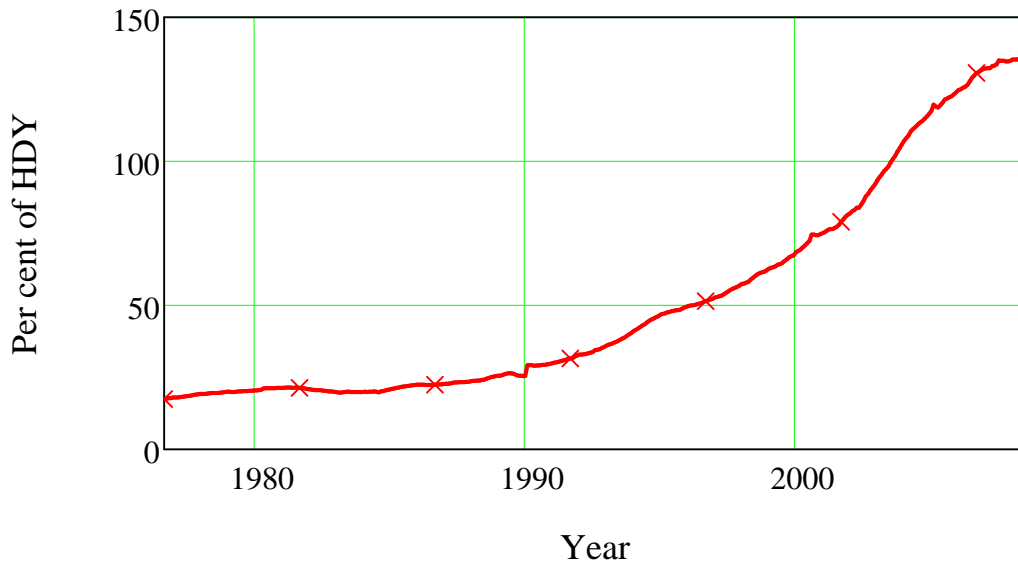
### Household Debt to Disposable Income



▢ Mortgage Debt to Household Disposable Income

**Figure 5**

### Mortgage Debt to Household Disposable Income

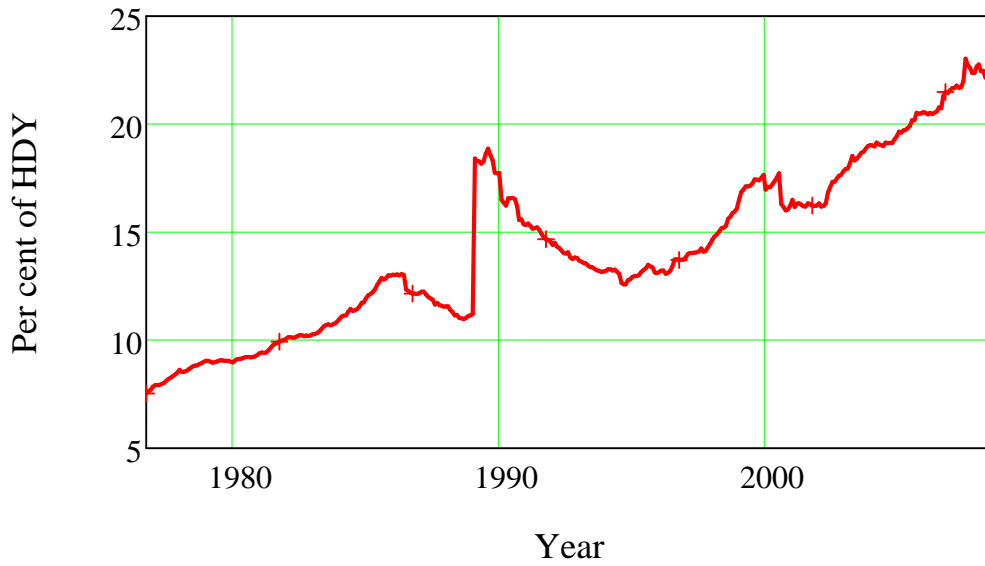


▢ Debt to Household Disposable Income

(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**

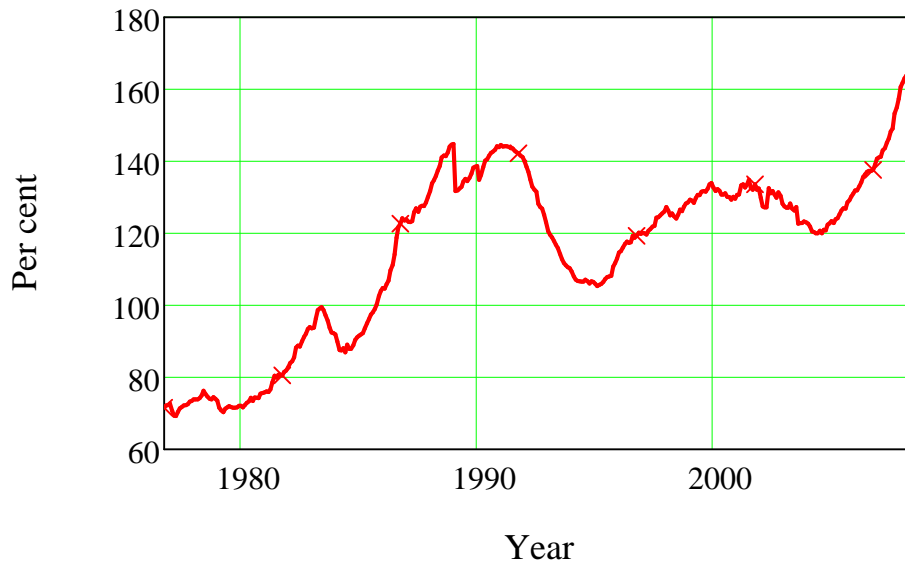
### Personal Debt to Household Disposable Income



▢ Business Debt to GOS

**Figure 7**

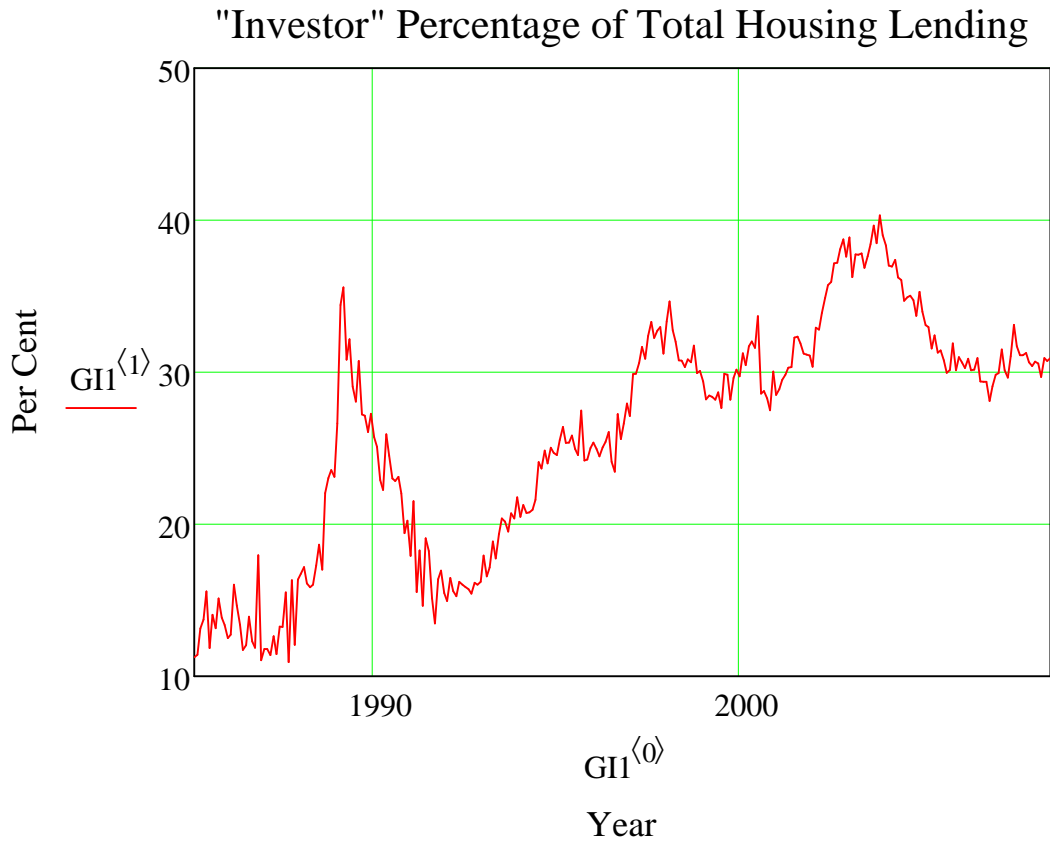
### Business Debt to Gross Operating Surplus



### **Housing Finance Analysis**

▢ Investment Percent Total Housing Lending

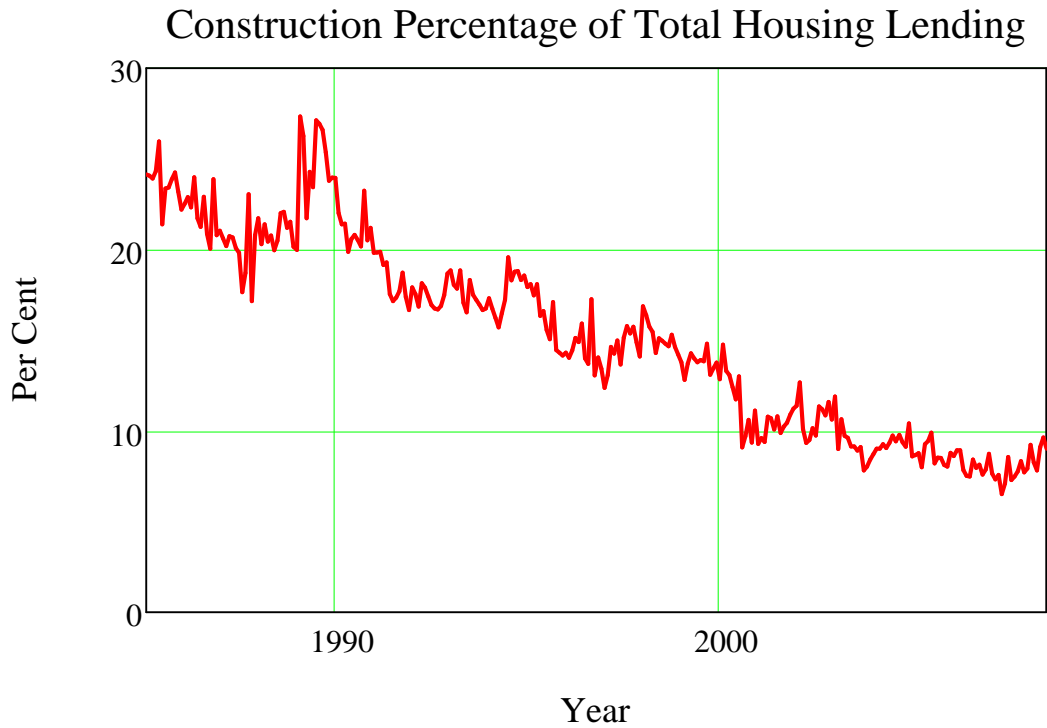
**Figure 8**



▣ Construction Percent Total Housing Lending

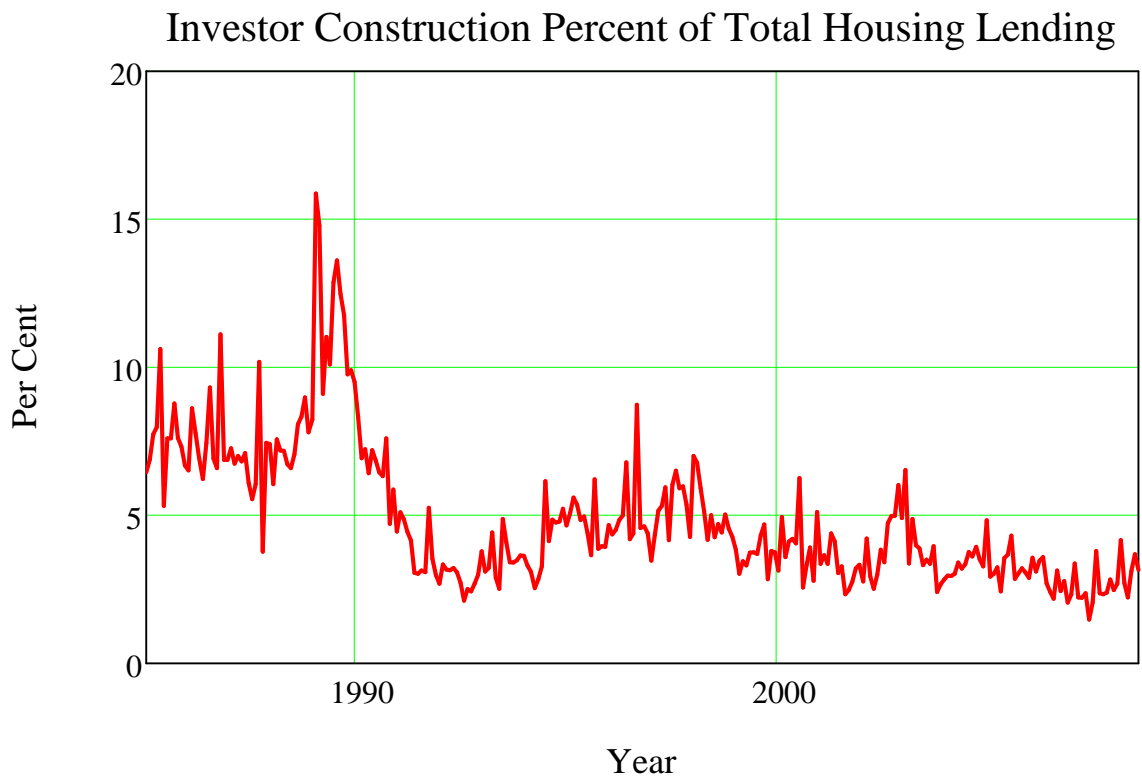
**Figure 9**





▢ Investment Construction Percent Total Housing Lending

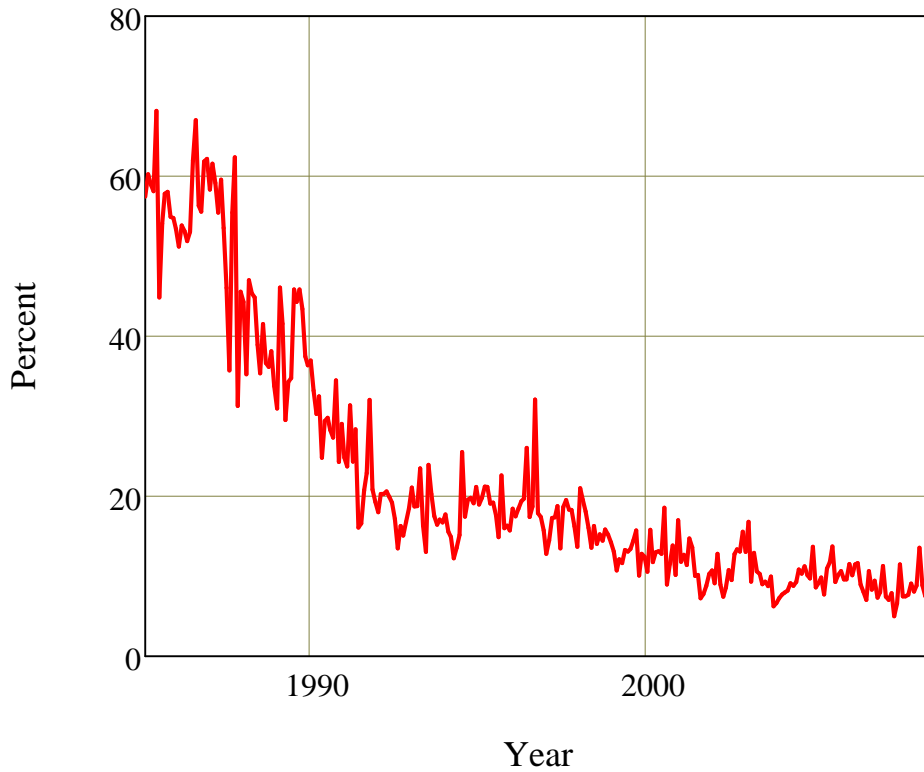
**Figure 10**



▢ Construction Percent of Investor Lending

**Figure 11**

### Construction Percent of Investor Lending



### Imputed Rent vs Mortgage Interest

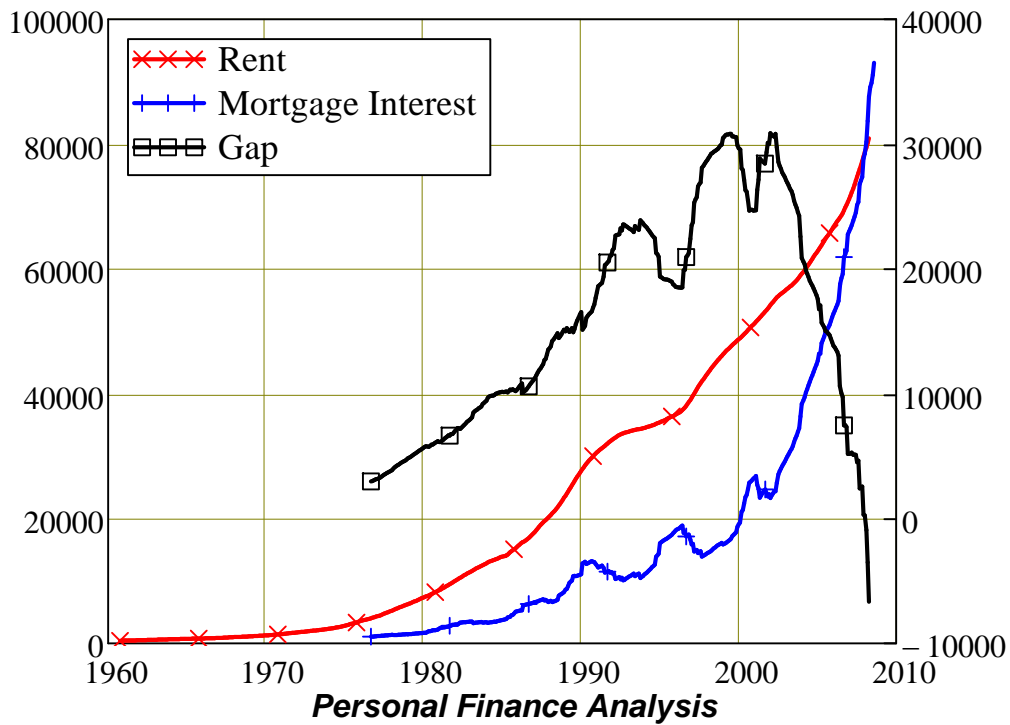
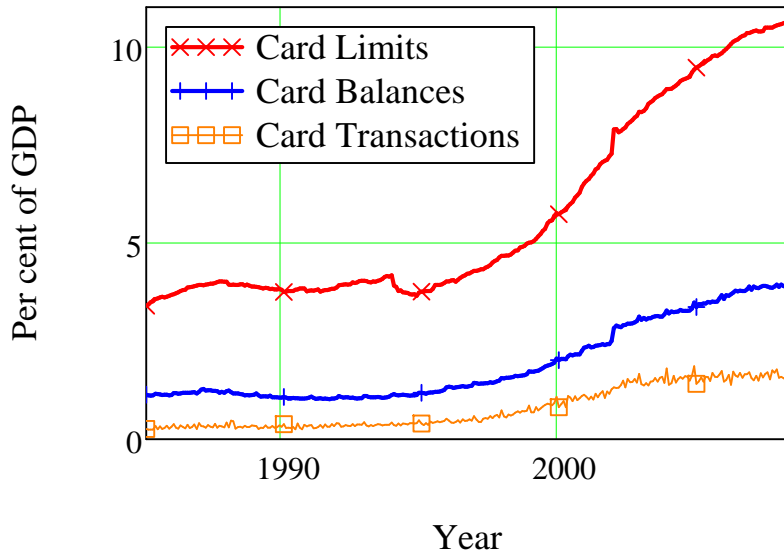


Figure 12

▣ Credit Card Data

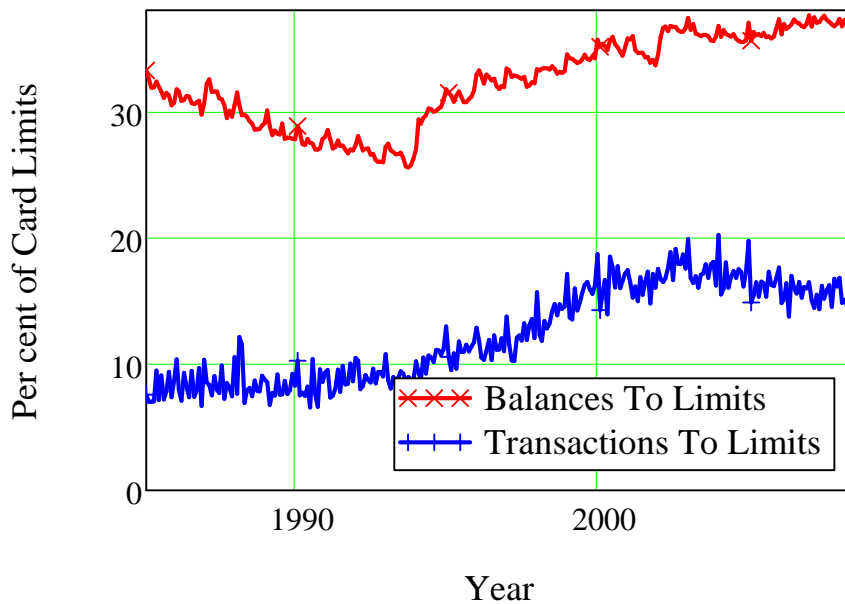
### Credit Cards To GDP



**Figure 13**

▢ Credit Card Data

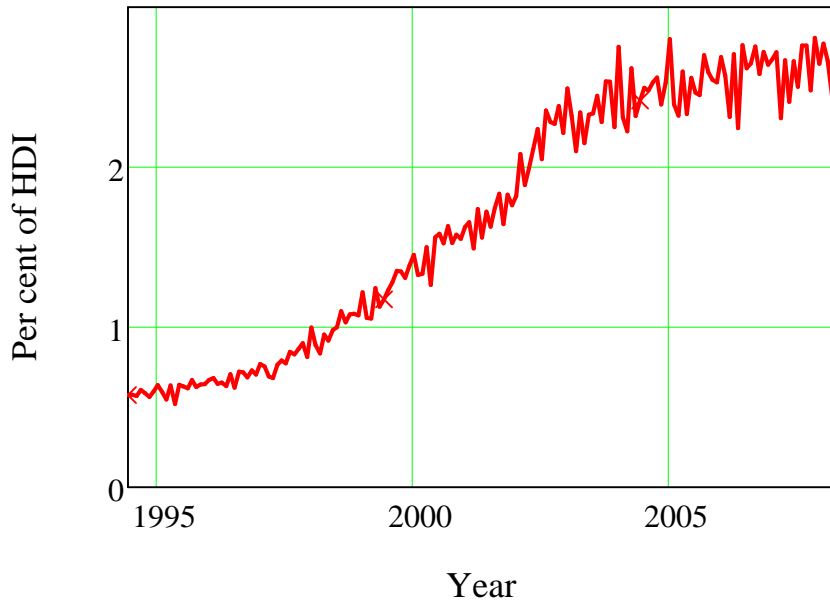
### Credit Cards Usage



**Figure 14**

▢ Credit Card Repayments

### Credit Card Repayments



▢ Debt components to Income

**Figure 14**

### Trends in Private Debt

