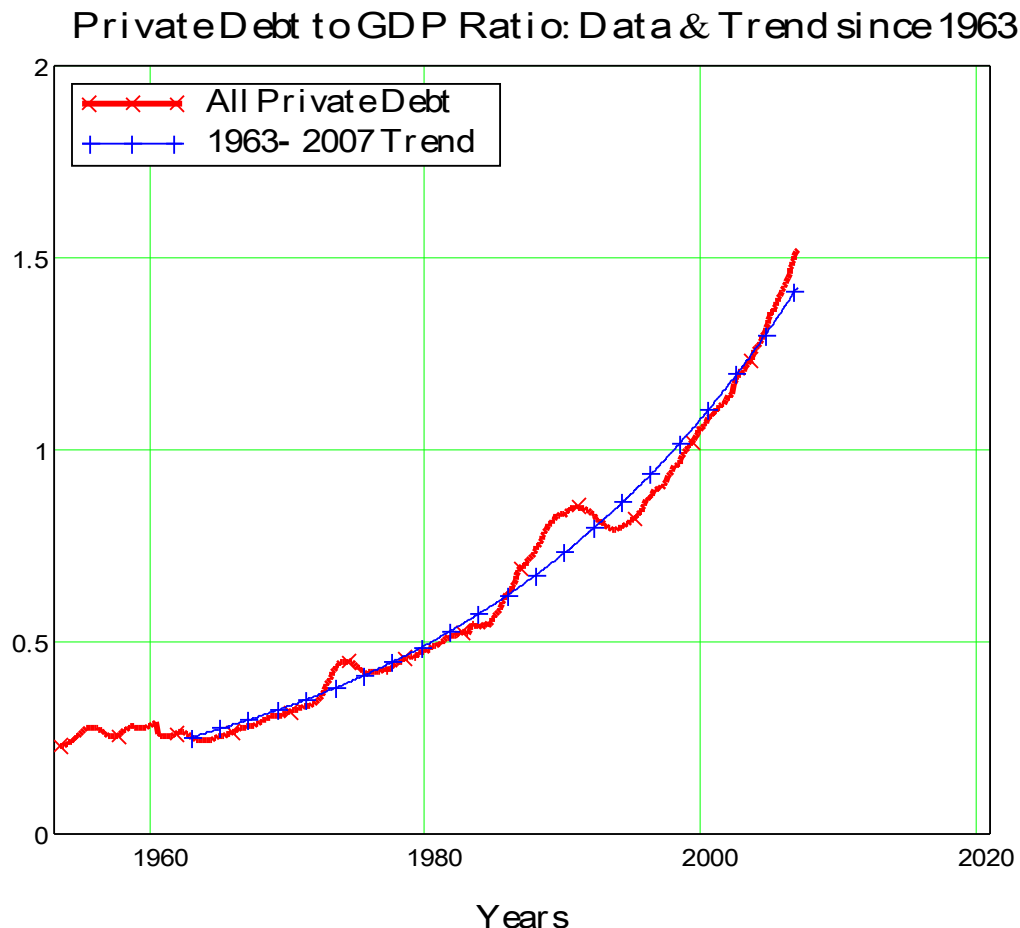


The elephant in Australia's economic living room

Even Paul Keating would have to concede that Australia's current economic managers are tabling “a beautiful set of numbers”. Unemployment is 4.5 per cent, the lowest it's been in 31 years. Inflation, while it rose a bit recently, is back to the 2 to 4 per cent range that was the rule in the 1960s. And though interest rates have been jacked up several times since the last Federal election, they are still at levels that were last commonplace in the early 1970s—before the OPEC oil price hike. Government debt is also down to effectively zero. Perhaps, as Keating also famously once said, the current government is finally “bringing home the bacon” of economic prosperity.

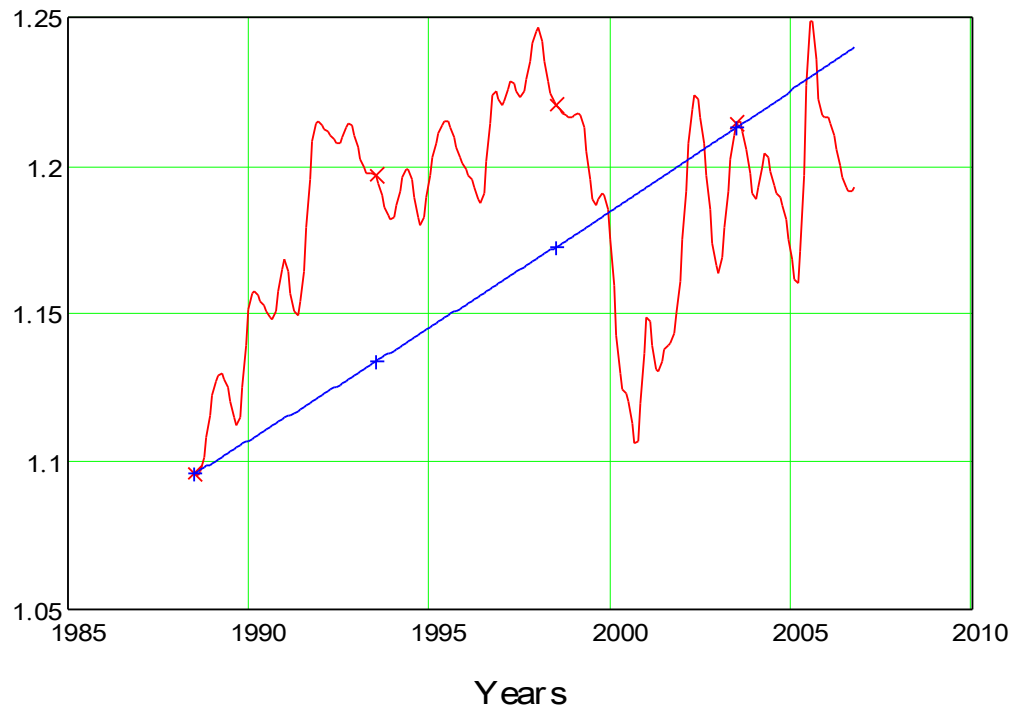
I want to sound a note of caution here, by putting the spotlight on another economic number that is also a record—and not just for the last thirty or so years, but in our recorded history. It's the ratio of private debt—the sum of business, mortgage and private debt—to GDP. This ratio has been hitting records every month since July 1995, when it exceeded the previous record set as the economy crashed from Paul Keating's pig farm into “the recession we had to have”. Then the ratio of private debt to GDP was 84 per cent. Now, it is 152 per cent, and it's rising by roughly one per cent every month.



So why aren't our economic managers crowing about this particular number? Well, mainly because in this case, it's obvious that bigger is not better: debt that is growing one per cent faster than your income *every month* is obviously not a good thing. They'd rather we ignore this number, and if it's ever raised, they argue that comparing debt to income is like comparing apples to eggs.

Better to consider the ratio of assets to liabilities, they say, and there the picture is a lot rosier. While the ratio is currently falling, it's still on the high side at 120 per cent, and it's a lot better than the roughly one to one figure that applied in the late 1980s. So even though Australians have taken on a lot of debt, it's more than amply covered by their assets.

Assets to Liabilities Ratio: Data & Trend since 1988



I beg to differ. Yes, the assets to liability ratio matters—and its lack of a trend implies that there's nothing untoward going on. But there's also a way in which that ratio is illusory.

Australians, of all people, should know that assets are often purchased with borrowed money—we call it “negative gearing”—and that it's motivated by the belief that the assets will increase in price.

As a result, the price of assets can depend on the level of borrowing—at least while asset prices are rising. The ratio can thus disguise what's going on because to some extent, the numerator depends on the denominator.

There's no such problem with the ratio of debt to income: borrowing money doesn't increase your income, though you might appear richer to others as you spend borrowed money. And the debt to income ratio matters, because ultimately the only way that debts can be serviced and repaid is out of income.

In contrast to the assets to liabilities ratio, where no trend is evident, there's an obvious and scary trend in the debt to GDP ratio: it's growing exponentially, it's been doing so for over 40 years, and its recent growth is even faster than the historic norm.

And it may be the real reason why the current government can otherwise present “a beautiful set of numbers”. While debt doesn't increase income, it does enable you to spend, and that spending enables houses to be constructed, workers to be hired, and so on. The numbers look great—so long as you ignore how they're being financed.

When you look at the complete picture, by including how expenditure has been financed, the numbers are no longer so appealing. Aggregate demand in any given year is the sum of income and the change in debt. Now that debt is so much larger than GDP, that annual increase in debt represents a large and growing fraction of overall spending.

If we go back to 1994, when the current boom began, the increase in private debt over the year was about \$32 billion, compared to (nominal) GDP in at the beginning of 1995 of \$507 billion: even then, the increase in debt accounted for about 6.5% of total spending.

Thirteen years later, the increase in debt over the year was \$196 billion, compared to annual GDP of roughly \$1,000 billion at the beginning of 2007. The increase in debt last year thus accounted for almost 16.5% of total spending.

How beautiful do you think the unemployment numbers would look if we reduced aggregate

demand by 16%?

The answer is doubtless unpleasant, but at some stage, we have to find out the answer. We will at least have to answer the related one of “what would happen if debt only grew as fast as GDP?”—because the ratio of debt to GDP can't keep on rising forever. It has to at least stabilise, which on current figures means a fall in aggregate demand of about \$100 billion—or about ten per cent. That is not a number that one can easily dismiss, and it's why I believe we're headed for, to coin a Keatingesque phrase, “the recession we can't avoid”.