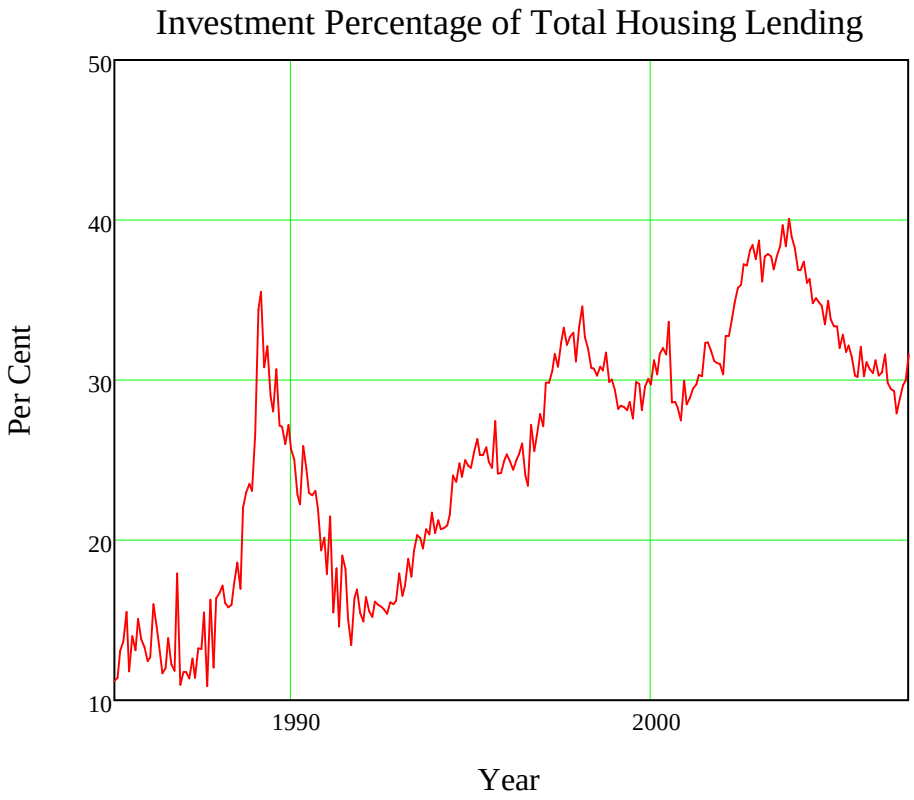
Keen Debtwatch June 2007

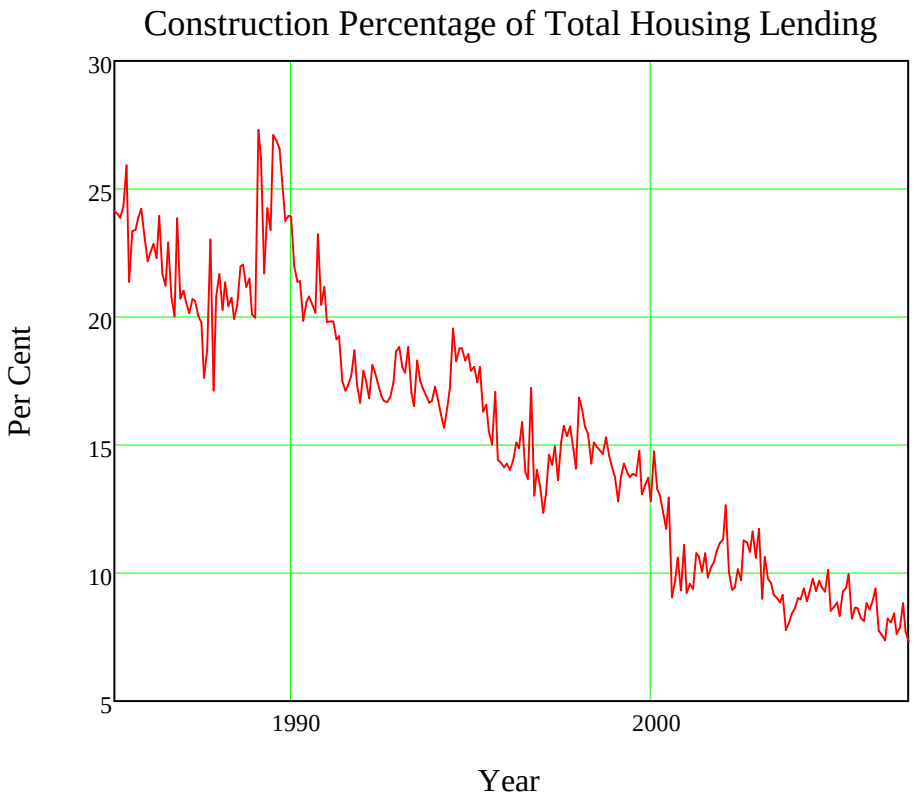
Commentary: Housing Speculation versus Housing Investment

There is a certain irony in the fact that, less than two years after the biggest housing bubble in history, the Eastern States are now experiencing a rental crisis caused by a shortage of available housing. How could this be, when a historically high proportion of lending during the bubble went to "investors"?

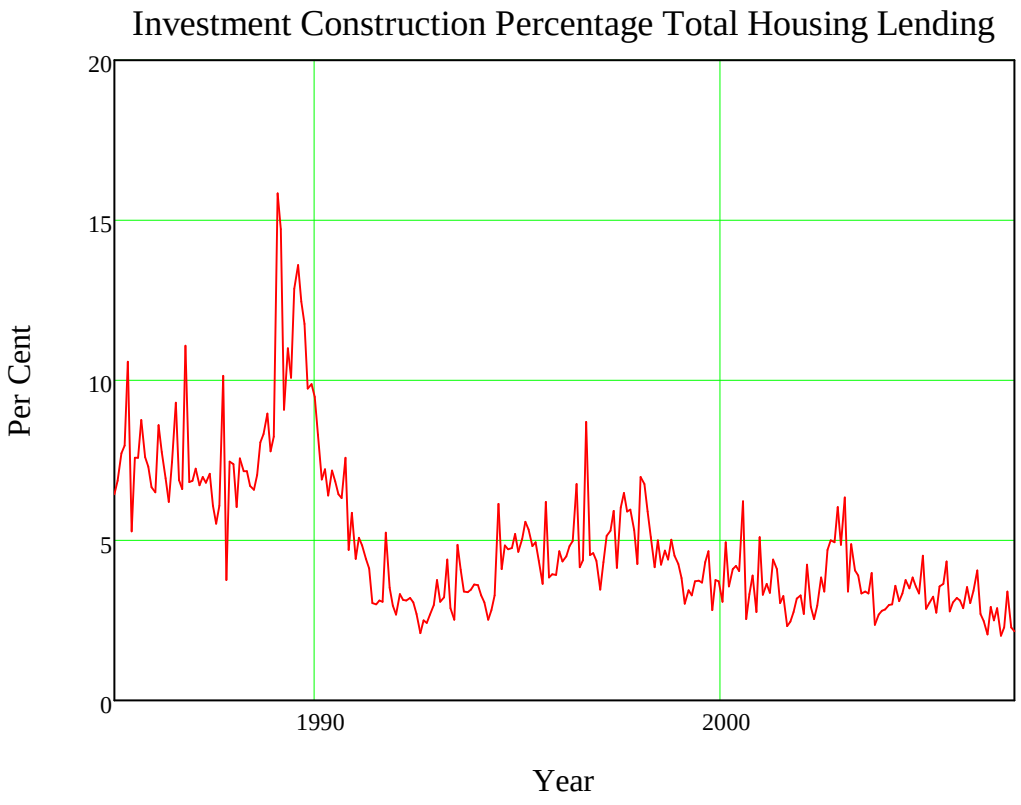


The irony disappears when you take a closer look at how the borrowed money was actually spent. Investors build something: they add to the country's capital stock. In housing, *real* investors build new houses--whether they live in them, or build them to rent out to others.

In that genuine sense, lending for real investment has never been a *smaller* proportion of total housing borrowing than it has today. In the 1980s, lending for construction accounted for 25 per cent of total lending. Now, it accounts for less than ten per cent of total new borrowing for housing.



Irony turns to pathos--as in "pathetic"--when one considers the proportion of lending that financed construction by investors. Even at its highest, this represented only 16 per cent of total lending in 1989; during the bubble, it was under 5 per cent, and it is now a piddling 2 per cent of new housing finance.



The rental crisis is no longer an irony, nor even a paradox, but a predictable consequence of allowing

speculation to dominate Australia's economic landscape.

Speculators do not produce anything: they simple gamble that the price of an asset is going to rise. Early in a speculative bubble, this is a "no brainer": the inflow of borrowed money drives prices up, and with rapid turnover and relatively low servicing costs, anyone can make money in a rising market.

But as this bubble went on, servicing costs rose dramatically--even before interest rates began to move--because of dramatically higher leverage. The ratio of housing debt to disposable income rose from 25 per cent to 135 per cent of disposable income between 1990 and 2007 (see Figure 5 below), pushing debt servicing costs into record territory. So the bubble came to an end--and left us with enormous debt, but a pathetic increase in the number of houses available for rent.

I can provide no better commentary on this than that which Keynes gave on a similar period of speculative excess over seventy years ago:

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." (Keynes 1936, p. 159)

Postscript

I am travelling at present in the USA, and unable to provide any media comment. However, I will be back in Sydney in time for the July meeting of the RBA.

Just the facts...

Australia's private debt to GDP ratio continued to rise--increasing from 153.52% in May to 153.86% this month. Though I'm not one to make much of monthly variations, this represents a *slight* slowing of the rate of growth of debt relative to GDP--from a 1.38% increase in May to a 0.93% increase this month. As a result, the year-on-year debt ratio increase also dropped, from 14.89% p.a. last month to 14.58% this month (see Table One).

However, all classes of debt rose relative to GDP--even personal debt, which historically has been the most stable form of debt (relative to GDP). That said, the personal ratio is now one per cent higher than its previous peak in mid-1989.

Otherwise, it's "business as usual": debt continues to rise faster than GDP, and from a higher base. 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 (see Figure 11).

The other notable trend is the drift of income from wages and "real economy" profits to "paper profits": the Finance share of GDP at factor cost is yet another record at 3.86%--almost four times the long term average (Figure 18).

Table One

$D_1 =$

	0	1	2
0	"Summary"	"Total Private Debt"	"Nominal GDP"
1	"Levels ($m)"	1567135	"N/A"
2	"Change Month $m"	14405	5582.46
3	"Change Month %"	0.93	0.56
4	"Change Year $m"	199430	69246
5	"Change Year %"	14.58	7.42
6	"Since 1990"	8.47	5.35
7	"Since 1980"	11.97	7.95
8	"Since mid-1964"	13.5	9.45
9	"% GDP"	153.86	100
10	"Growth rate"	6.95	0
11	"Since 1990"	2.85	"N/A"
12	"Since 1980"	4.09	"N/A"
13	"Since mid-1964"	4.17	"N/A"
14			

Table Two

$D_2 =$

	0	1	2	3
0	"Detail"	"Business"	"Mortgage."	"Personal"
1	"Levels ($m)"	585884	843531	137719
2	"Change Mth $m"	5413	8554	438
3	"Change Mth %"	0.93	1.02	0.32
4	"Change Yr $m"	82369	100178	16883
5	"Change Yr %"	16.36	13.48	13.97
6	"Since 1990"	4.76	14.73	5.29
7	"Since 1980"	10.62	14.03	10.44
8	"Since 1976"	11.16	14.31	11.24
9	"% GDP"	57.54	82.84	13.52
10	"Growth rate"	8.64	5.95	6.41
11	"Since 1990"	-0.89	9.29	-0.5
12	"Since 1980"	3.02	6	2.61
13	"Since 1976"	3.09	5.75	2.99
14				

Standard Charts

Debt to Income Ratios

Figure 1

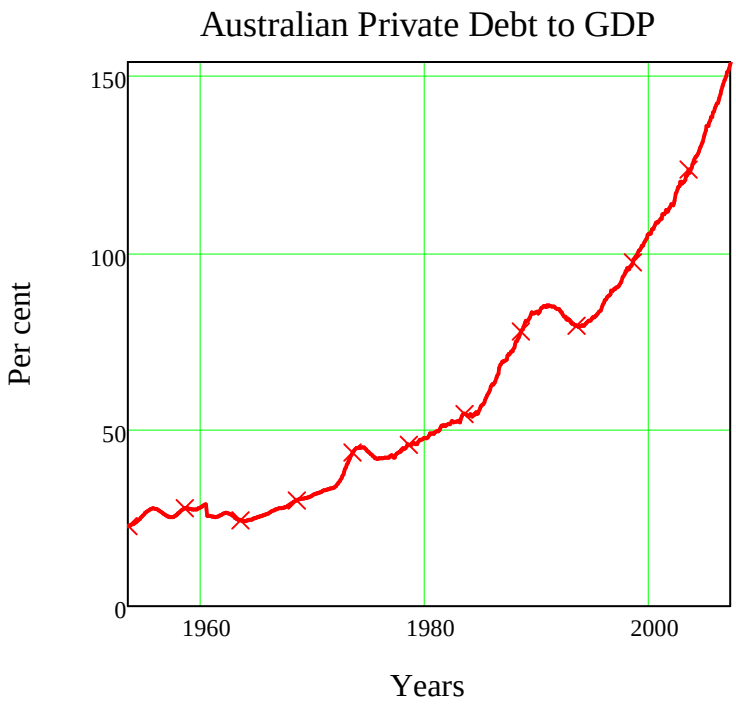


Figure 2

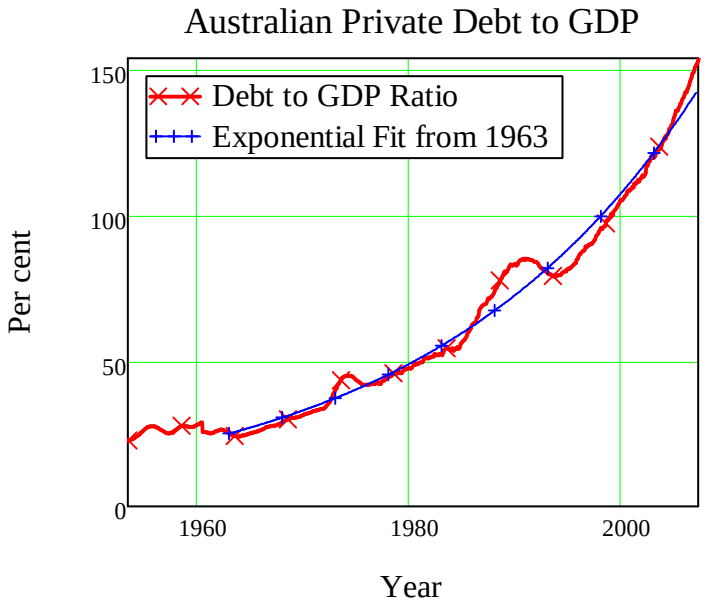


Figure 3

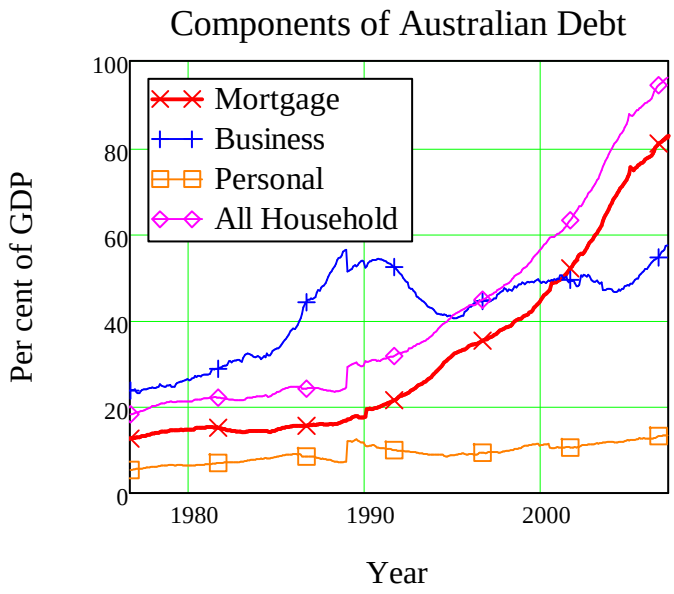


Figure 4

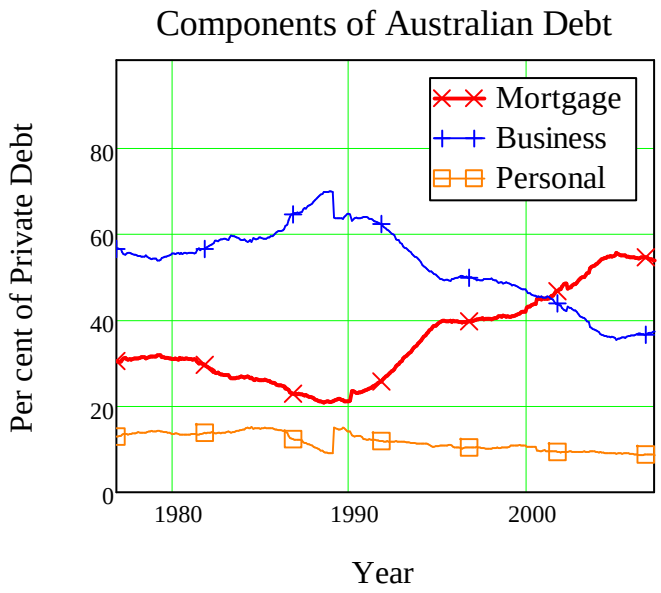


Figure 5

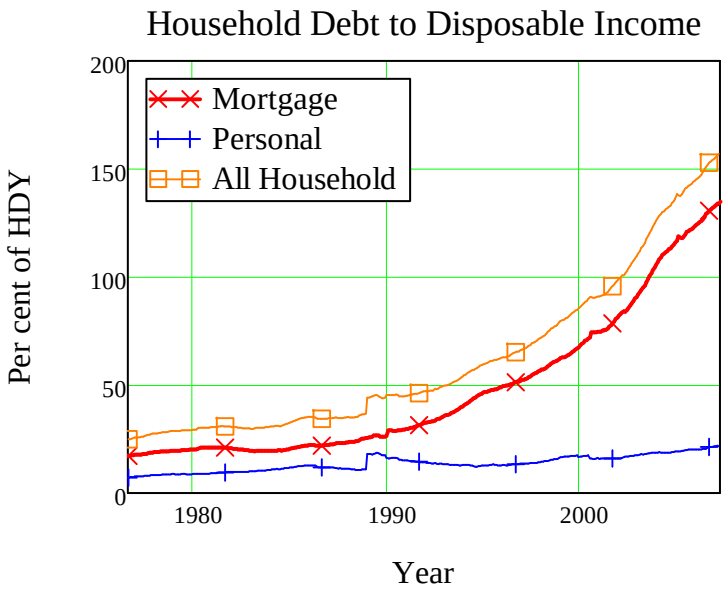


Figure 6

Figure 7

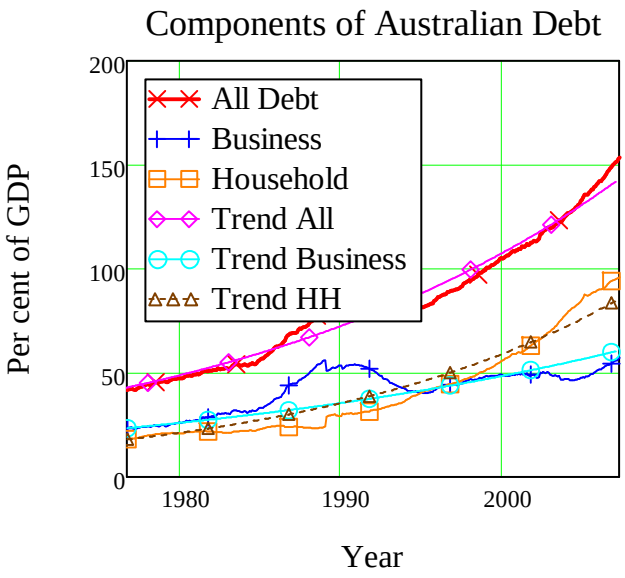
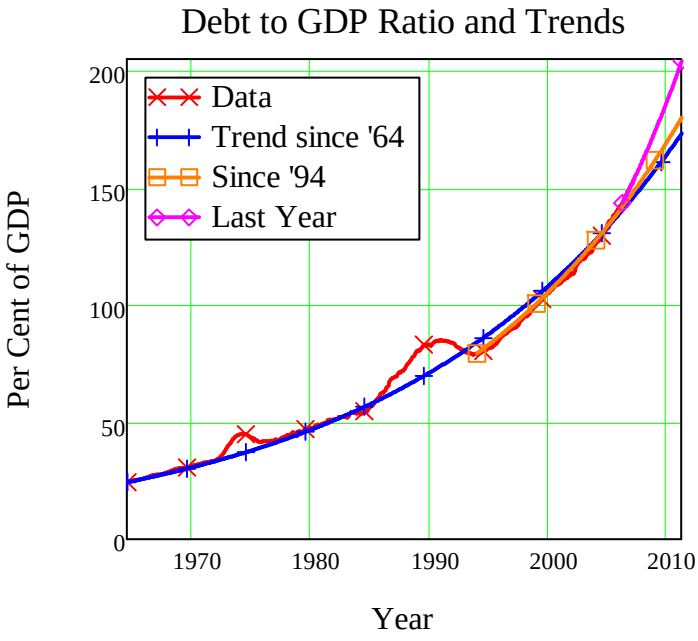


Figure 8



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

Corr77 =

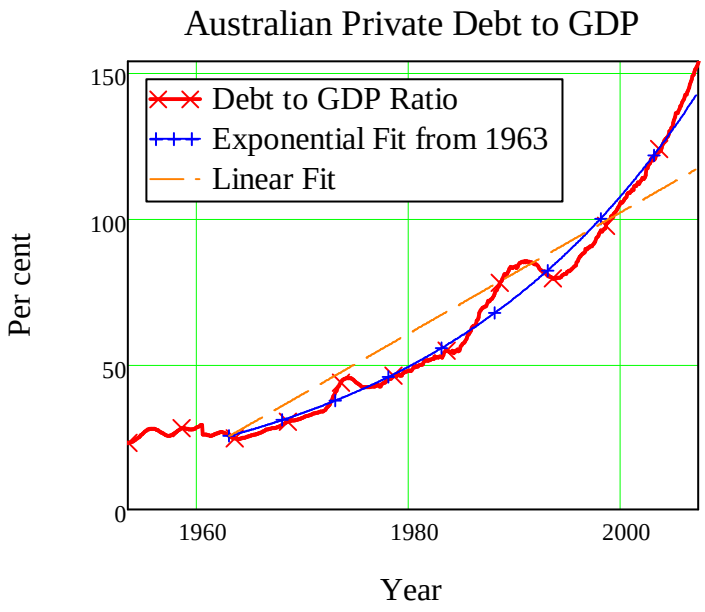
"Debt ratios"	"All"	"All"	"Business"	"Household"	"Mortgage"
"Start Date"	"mid-1964"	1977	1977	1977	1977
"Growth rate"	4.17	4.05	3.09	5.07	5.75
"Correlation"	99.11	98.42	73.77	98.1	97.98

Table Four

Corr90 =

"Debt ratios"	"All"	"Business"	"Household"	"Mortgage"
"Start Date"	1990	1990	1990	1990
"Growth rate"	2.81	–0.95	6.82	9.32
"Correlation"	96.45	–19.03	99.67	99.76

Figure 9



Debt Servicing Burden

Figure 10

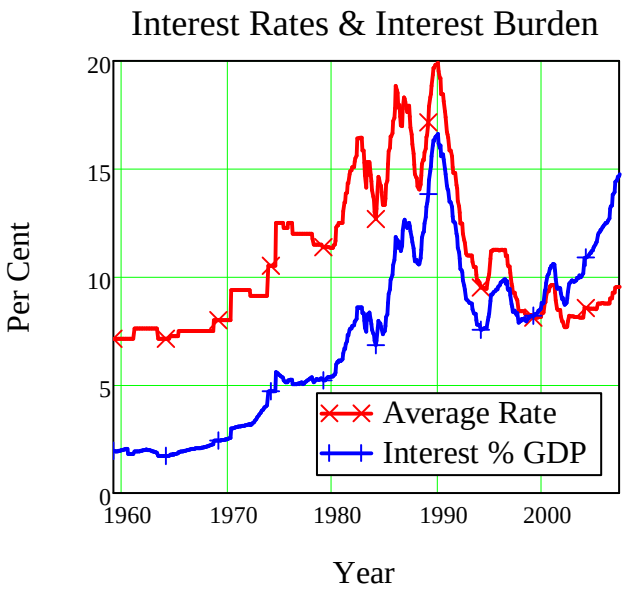


Figure 11

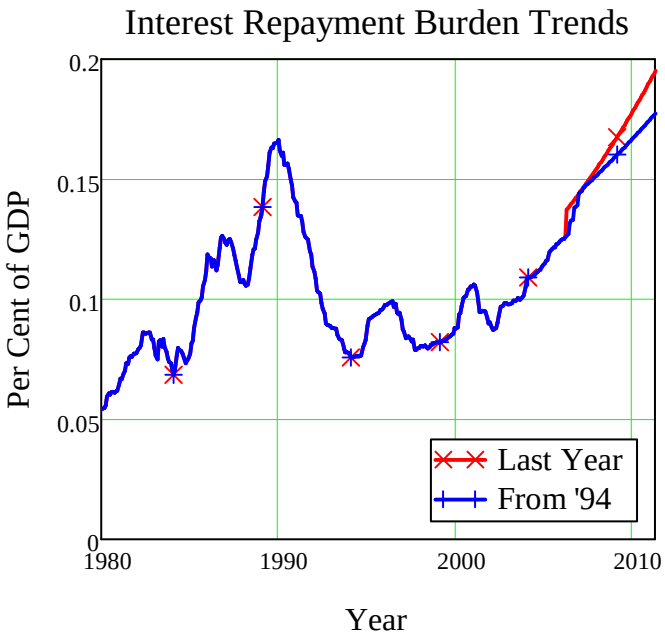


Figure 12

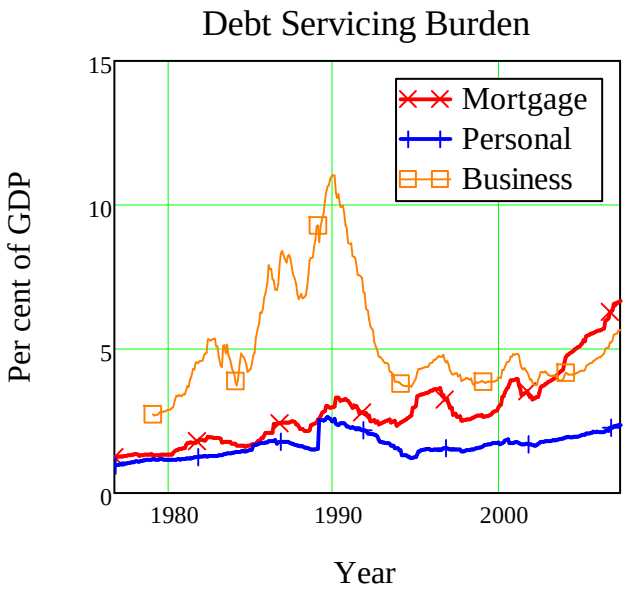


Figure 13

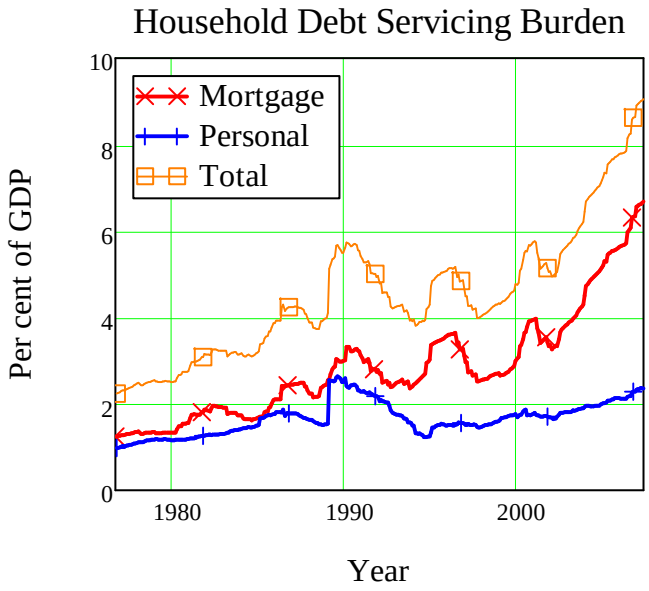
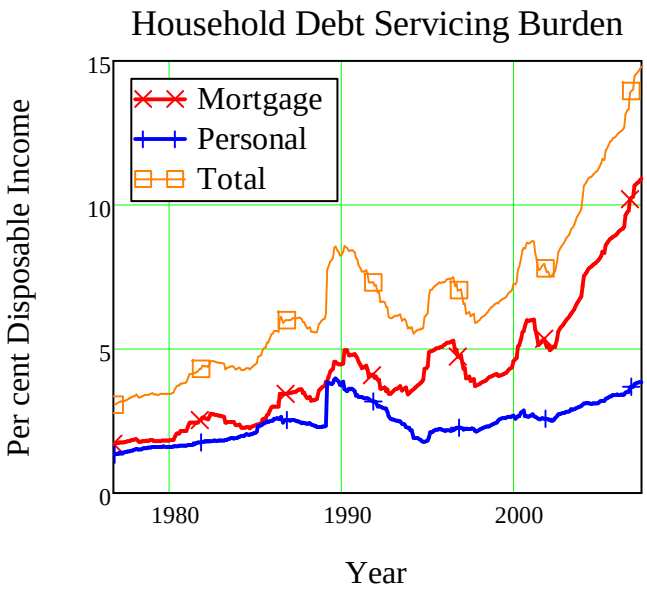


Figure 14



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 over 72 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 15

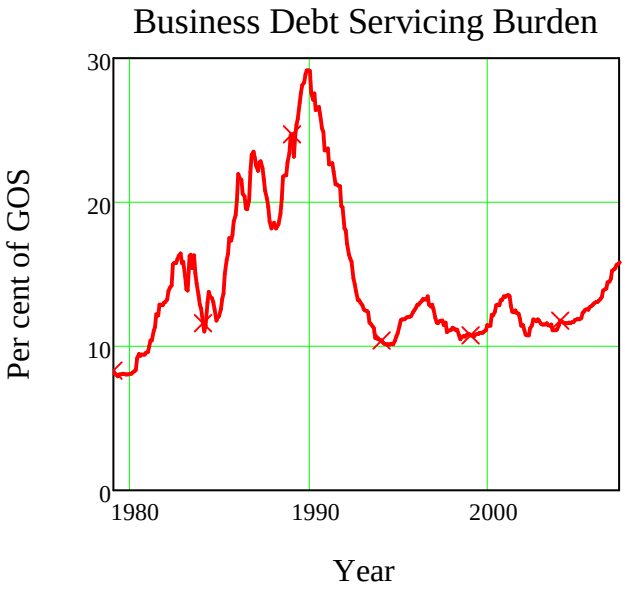
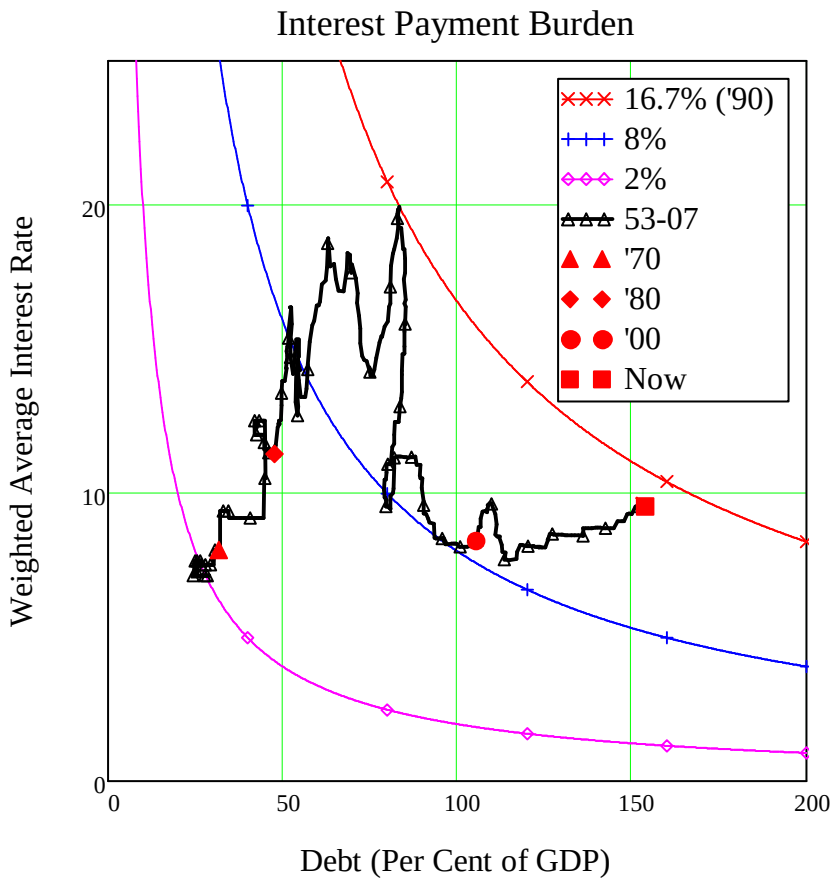


Figure 16



Income Shares

Figure 17

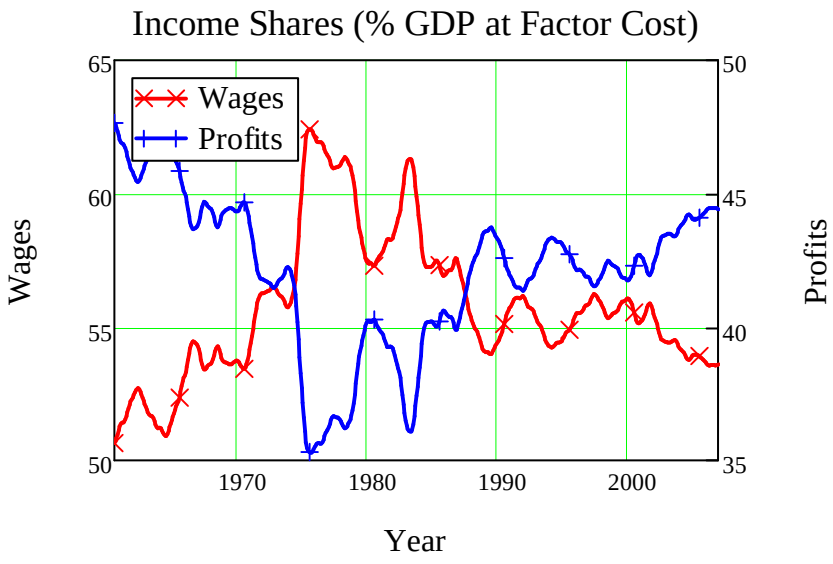
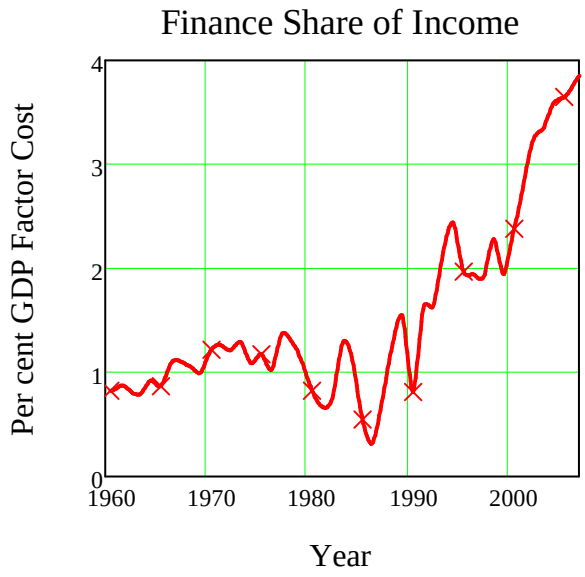


Figure 18



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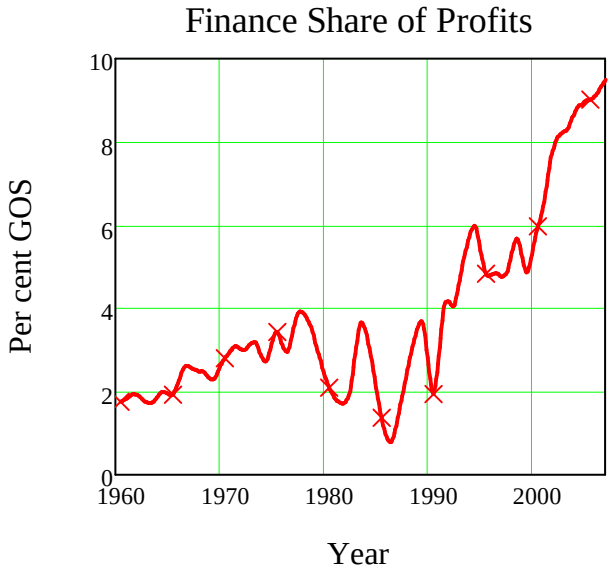
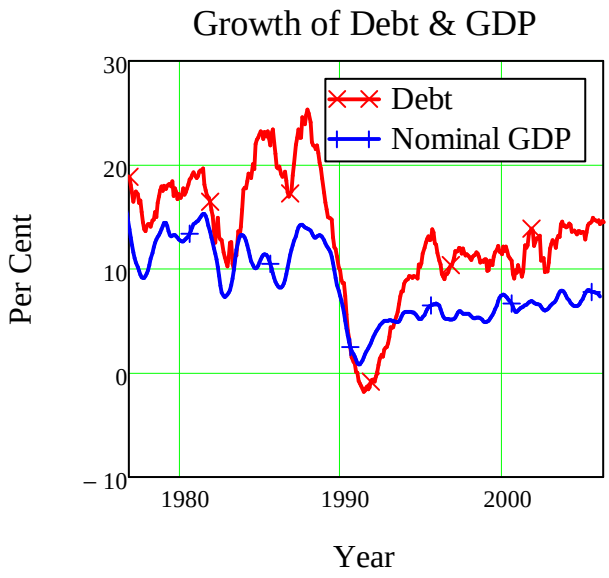


Monetary Aggregates

Debt contribution to Effective Demand

Figure 20



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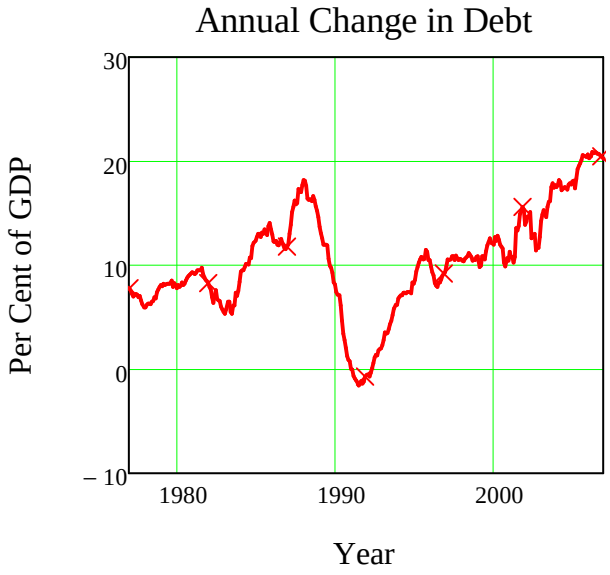

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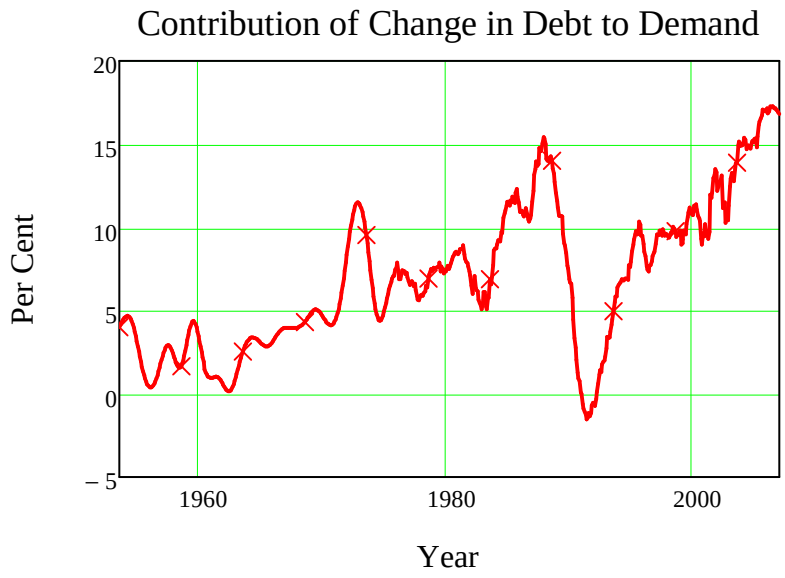

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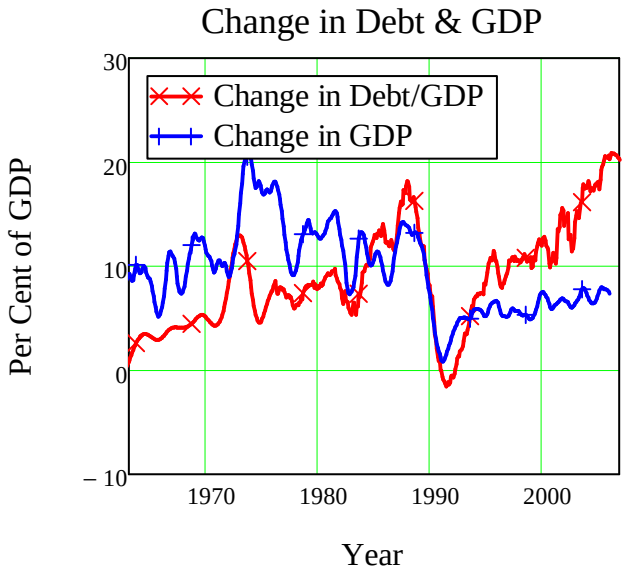

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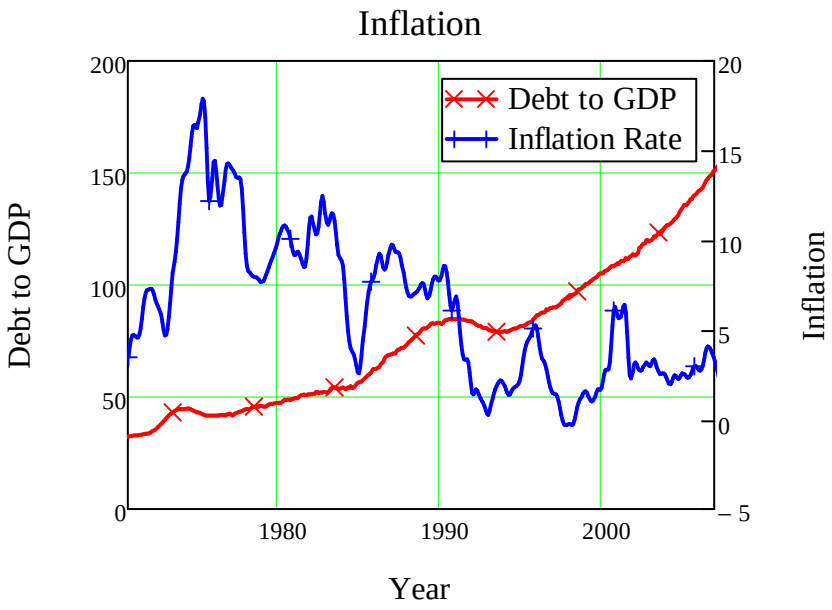
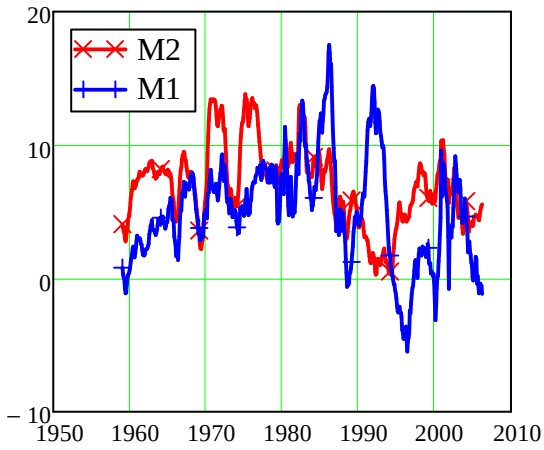

Inflation
Debt to GDP
Inflation Rate
Debt to GDP
Inflation
Year
200
150
100
50
0
20
15
10
5
0
– 5
1980
1990
2000


M2
M1
20
10
0
– 10
1950
1960
1970
1980
1990
2000
2010