



Steve Keen's Debtwatch No. 32 March 2009

Is Rudd the new Whitlam?

A quick quiz: when did Australia's biggest private debt bubble burst?

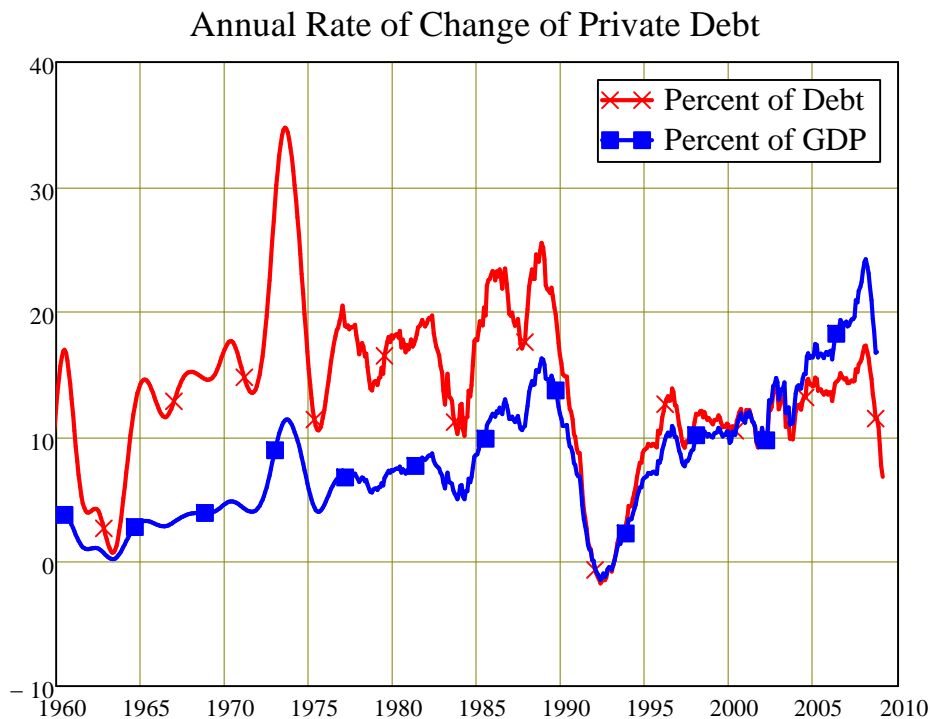
If you consider the rate of increase of debt, the correct answer is "in mid-1973". The bubble started to expand a year *before* Whitlam came to power, and its collapse during Whitlam's term was the real--but at the time, unappreciated--cause of the economic crisis that undid his government.

However, if you consider the rate of growth of debt *relative to GDP*, the correct answer is "in early 2008". This bubble started well before the Rudd Government came to power--its origins can be traced back to the depths of the 1990s recession, when private debt was *falling* at

about 1.5 percent per annum--and its bursting shortly after Rudd assumed office is the cause of the domestic financial crisis we are only just entering.

Today, there is general awareness that the economic crisis is not Rudd's fault--since a global economic crisis was well underway by the time of the 2007 election campaign--in marked contrast to the way that Whitlam's government has been unjustly demonised in Australia's popular economic history. But how Rudd's government responds to this far greater crisis will determine whether it goes down in history as "Whitlamesque".

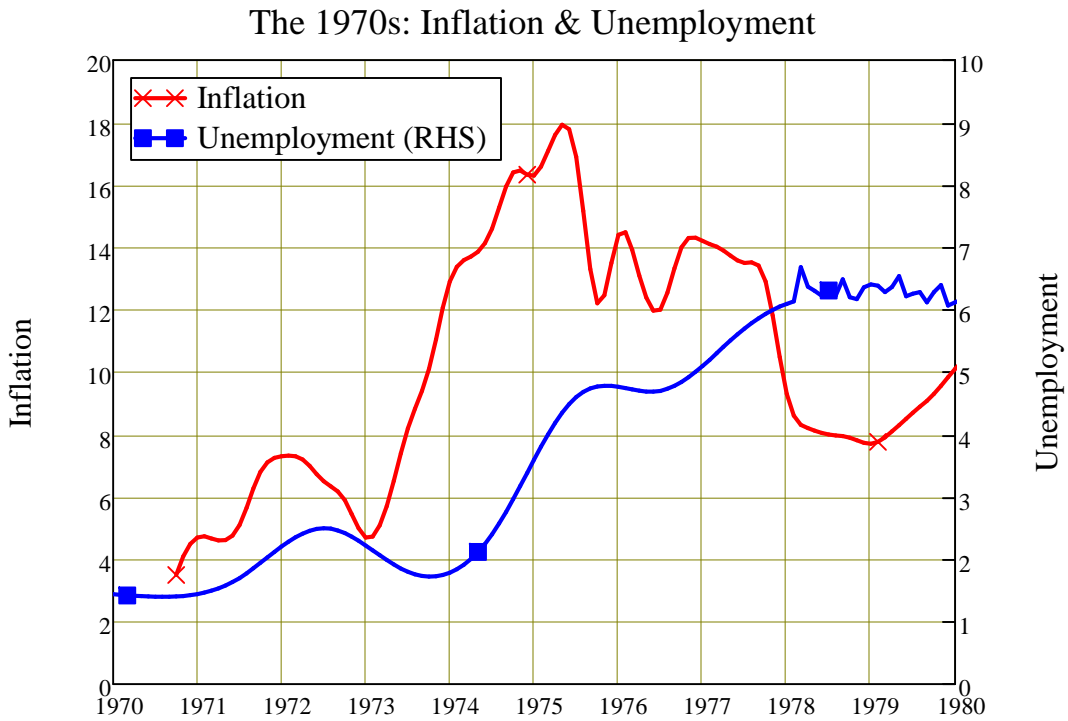




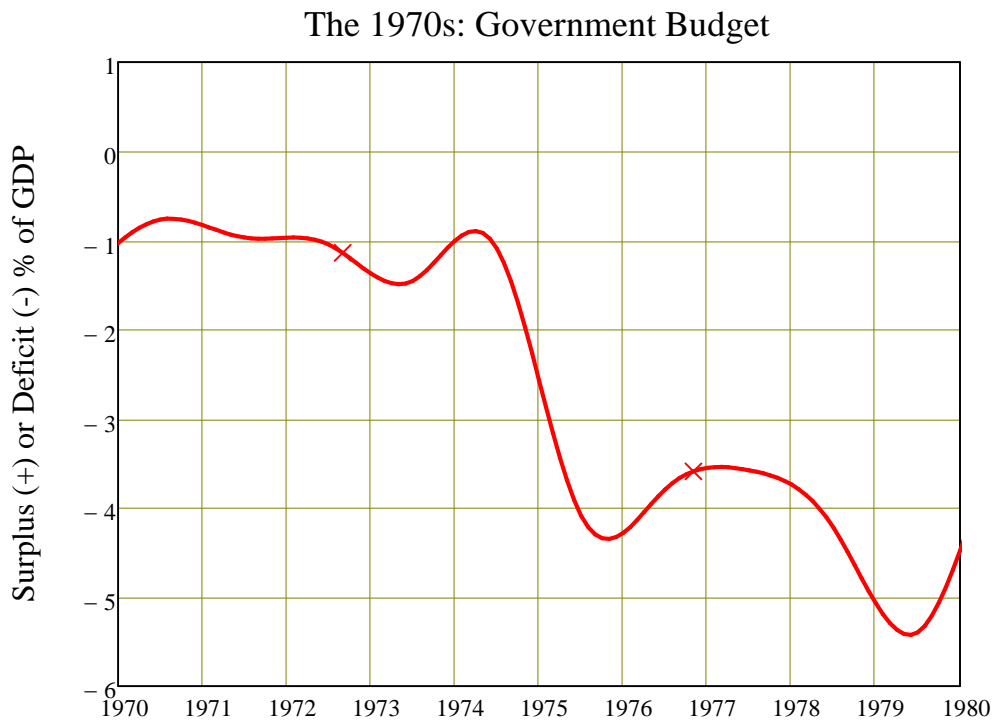
In December 1972, the ALP (Australian Labor Party) defeated the Liberal Party, which had held office for 23 years. Led by the charismatic Gough Whitlam, it won even though its incumbent rivals could take the credit for a booming economy, because voters took good economic performance for granted. The ALP promised to reverse many of the unpopular social and foreign affairs policies of the incumbent conservative political party--most notably its support for the American war in Vietnam--and this secured them the majority of votes.

Once in office, it quickly set about reversing those policies, starting with a withdrawal from the war in Vietnam on literally its first day in office. It truly began its term in office with a bang.

It departed the same way, a mere three years later, sacked by the Governor-General, and voted out of office at the subsequent elections. The cause of its defeat was an economic crisis that saw unemployment climb from 2.3% at the time of its election, to 4.8% at the time of its dismissal. Simultaneously, inflation exploded from a mere 5% when it was elected, to a peak of 18% in the months leading up to its collapse. When the electoral door was emphatically slammed in its face by the Australian electorate, inflation was still running at 14% p.a.



Government finances were also in tatters. The Government deficit had been running at 1% of GDP when it took office, blew out to 4.3% of GDP by the time of the government's demise.



Though the ALP continues to treat Gough Whitlam with great reverence, the reputation his government gained for economic incompetence is one that the ALP has spent decades distancing itself from. The ALP remains progressive (or in the American parlance, "liberal") on social issues, but ever since the election of the Hawke Labor Government in 1983, it has proudly declared itself to be economically conservative: in favour of small government, low inflation, government surpluses, and the privatisation of inefficient state enterprises (Hawke's ALP had won office on the back of an election manifesto called *The Accord*, which had many not-so-conservative elements, but most of these were rapidly abandoned once the party was in office).

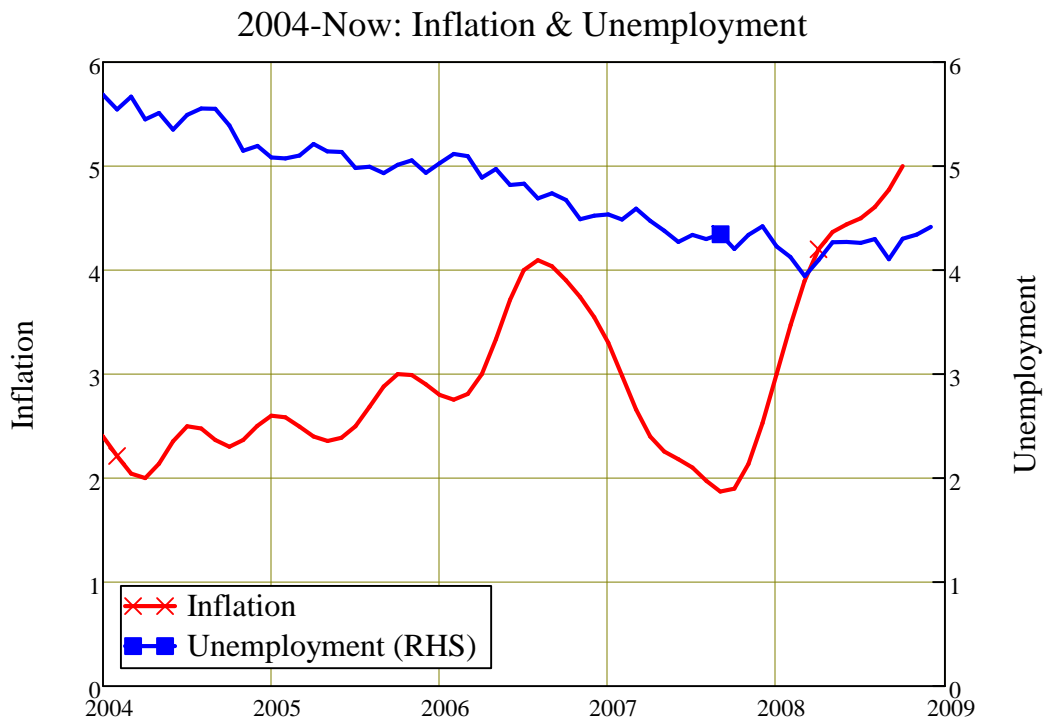
Rudd--Whitlam Mark II?



In November 2007, the ALP defeated the Liberal Party, which had held office for 11 years. Led by the outwardly affable Kevin Rudd, it won even though its incumbent rivals could take the credit for a booming economy, because voters took good economic performance for granted (well, that was how the Liberal Party reacted to the news of its impending demise). The ALP promised to reverse many of the unpopular social and foreign affairs policies of the Liberal Government--most notably harsh industrial relations laws and its uncritical support for the American war in Iraq.

Once in office, the ALP set up lots of enquiries to consider what to do about those policies, and reversed a few of them--most notably the refusal of John Howard's Liberal Party to apologise to Aboriginal Australians for their treatment under the racist laws that prevailed before the repeal of the White Australia policy by the Whitlam Government in 1973.

The ALP kept its promise to maintain the economic conservatism of its political rivals--in fact, it attempted to be even more conservative than they were by running an even bigger Budget surplus. The intention was to do help reduce inflation (which was 3 percent at the time of the election, and rising rapidly) and thus discourage Australia's independent central bank, the Reserve Bank of Australia (RBA) from increasing interest rates any further. The first Rudd Budget even planned for an increase a slight rise in unemployment to the still acceptable level of 4.75 percent.



Then the Global Financial Crisis hit. The Rudd Government rapidly switched from so-called conservative positions on economic policy--"inflation is public enemy number one" and "budget surpluses are good policy"--to "forget inflation and man the fiscal pumps".

The same policy switch is happening all over the world in response to this unprecedented crisis, but the abrupt switch in policy by Rudd has led some observers--particularly the Liberal Party opposition leader Malcolm Turnbull--to raise the spectre of Whitlam.

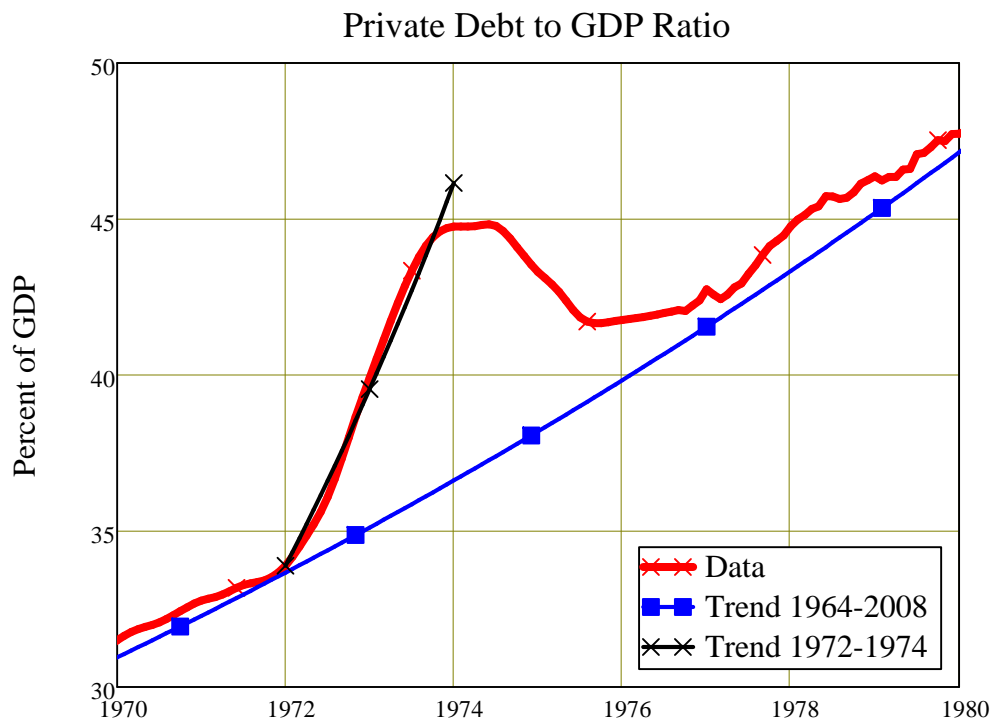
Turnbull's political spin has rightly been mocked by the media--Paul William's thoughtful piece in the Australian is a good instance of this (Whitlam insult used as ultimate political insult; <http://www.news.com.au/couriermail/story/0,23739,25062495-27197,00.html>)--but there is a way in which it is quite apt to compare Rudd to Whitlam on economics.

Whitlam's Government was undone by a debt-induced economic collapse that it didn't see coming, and Rudd's Government may well go the same way.

Regular readers of Debtwatch will be familiar with the fact that private debt (the sum of business and household debt) has grown faster 4.2% than nominal GDP for the 44 years from mid-1964 to mid-2008. This debt bubble was the cause of our apparent but illusory prosperity in the past 3 decades, and its bursting (along with that of many similar bubbles in our trading partners) is the real cause of the current economic downturn.

There are however two obvious super-bubbles on that overall bubble. In the first, which began in 1972 a year before the election of the Whitlam government, debt exploded from a mere 33.67 percent of GDP to 44.75% in just two years. *It was the bursting of this debt bubble, and not any actual economic mismanagement by Whitlam's ALP, that caused the economic crisis that ended*

his government.



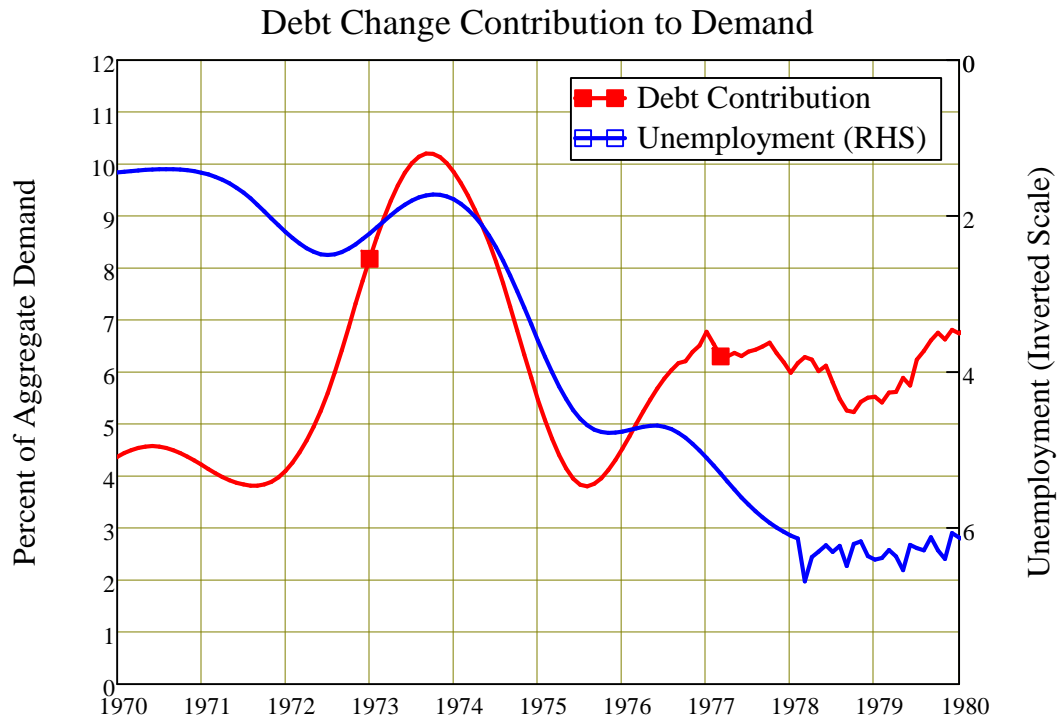
Undone by debt

The debt growth rate accelerated dramatically during this superbubble. Debt grew 4.2% faster than GDP for the whole 44 year period, but 15.5% faster over this two year extravaganza. As a result, even though the debt was much smaller relative to GDP than it is now, the increase in debt made a huge contribution to aggregate demand: in 1974, the increase in debt accounted for more than 10 percent of aggregate spending in the Australian economy, up from just 4 percent a year earlier.

The growth in debt financed spending fuelled a stock market boom, and helped to drive unemployment down from 2.5% in mid 1972 to 1.75% by mid 1973.

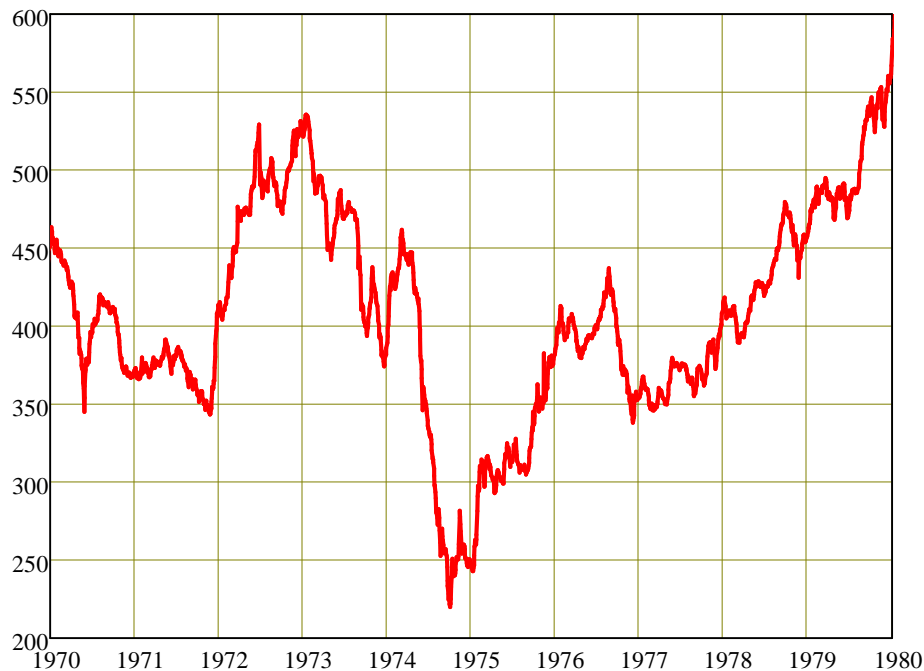
But this superbubble was clearly unsustainable, and it had to burst: if it had instead kept going, private debt would now be equivalent to over 100 times our GDP, versus the still unsustainable current ratio of 1.75 times GDP (when corporate bonds are factored in).

When the 1972 superbubble burst just two years after it started, the change in debt went from adding to demand to subtracting from it, and both the economy and the stock market tanked.



Unemployment rose from 1.75% to 5%, while the Stock Exchange lost 59% from its peak in January 1973 to its low in September 1974. At the time, this was the biggest stock market crash since the Great Depression, but this seems to have been forgotten, while the Whitlam Government is remembered--and blamed--for the consequences of financial events that began before it took office, and which overwhelmed it without it even being aware of them.

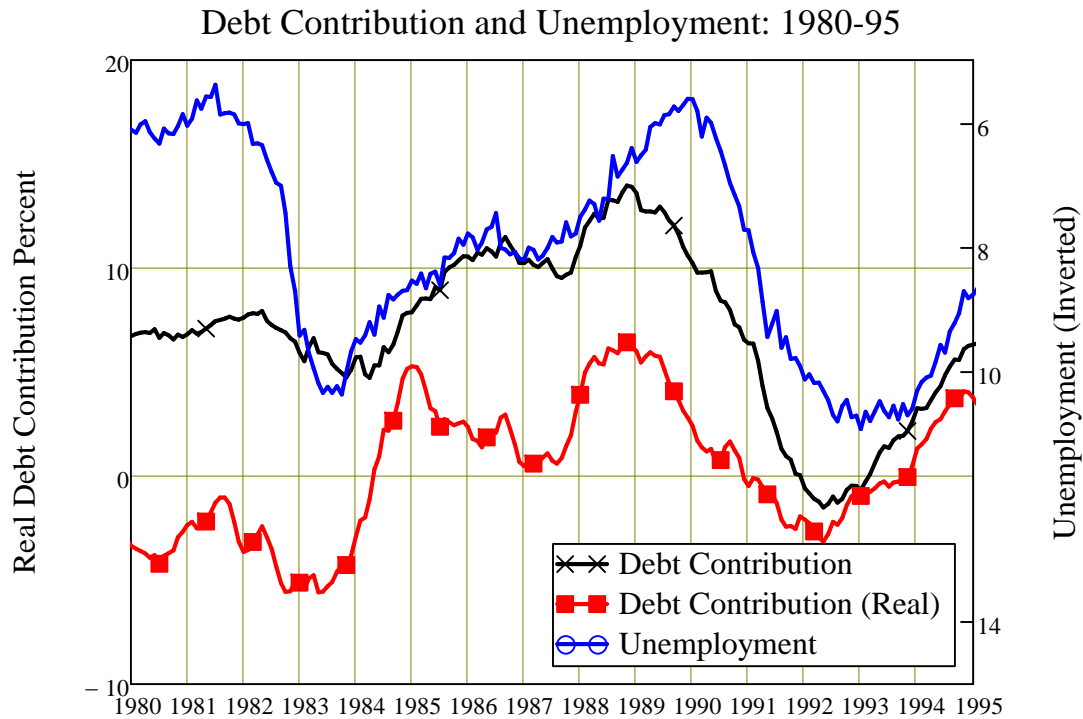
Sydney Stock Exchange All Industrials Index



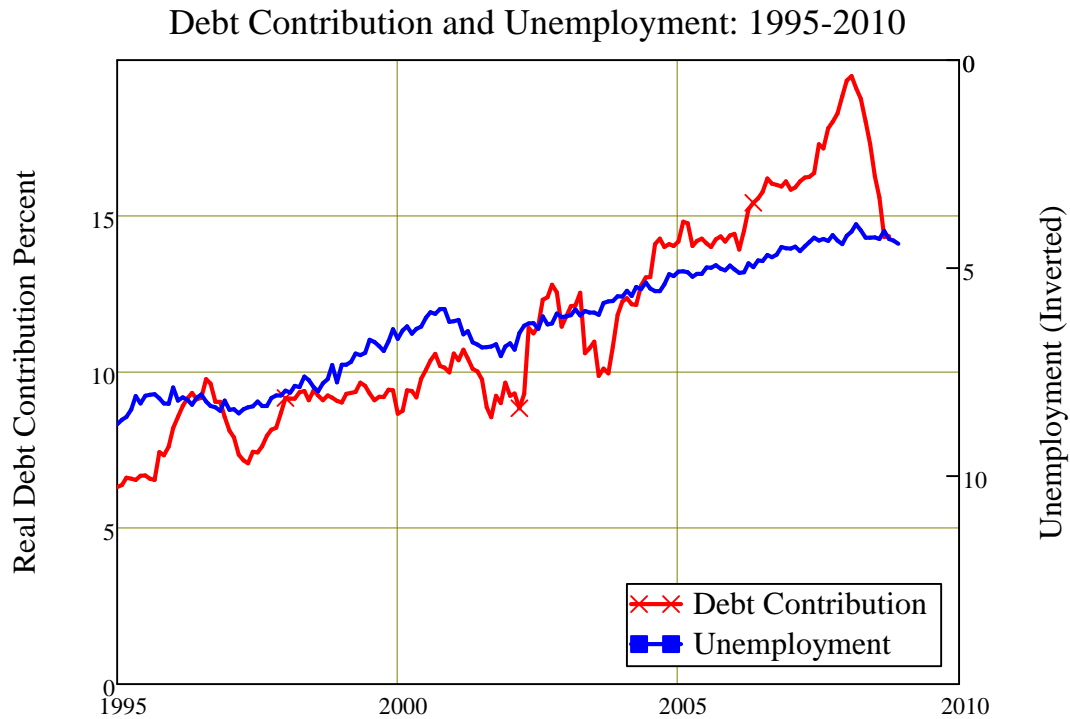
Thus while bad economic management by Whitlam and his Treasurer Jim Cairns, OPEC's oil price hike, and excessive wage demands by trade unions took the rap, the real killer of the Whitlam Government was private debt. The Whitlam Government was unlucky enough to come to power when the lessons of the Great Depression had been thoroughly forgotten, when a rising level of debt had started to dominate economic activity, and when what is probably the greatest ever debt bubble in human history had its first stumble.

The same pattern of rising debt dependence continued after Whitlam's demise--and became more marked as debt grew relative to GDP--so that even relatively small changes in debt compared to the 1972-74 superbubble could have a large impact on demand. The recession that ended the Fraser Liberal Government's term in 1983 was also driven in part by a decline in debt's contribution to demand.

The boom under Hawke and Keating between 1984 and 1989 was emphatically driven by rising debt, while Paul Keating's "recession we had to have" in 1990 was caused by the bursting of a debt bubble.



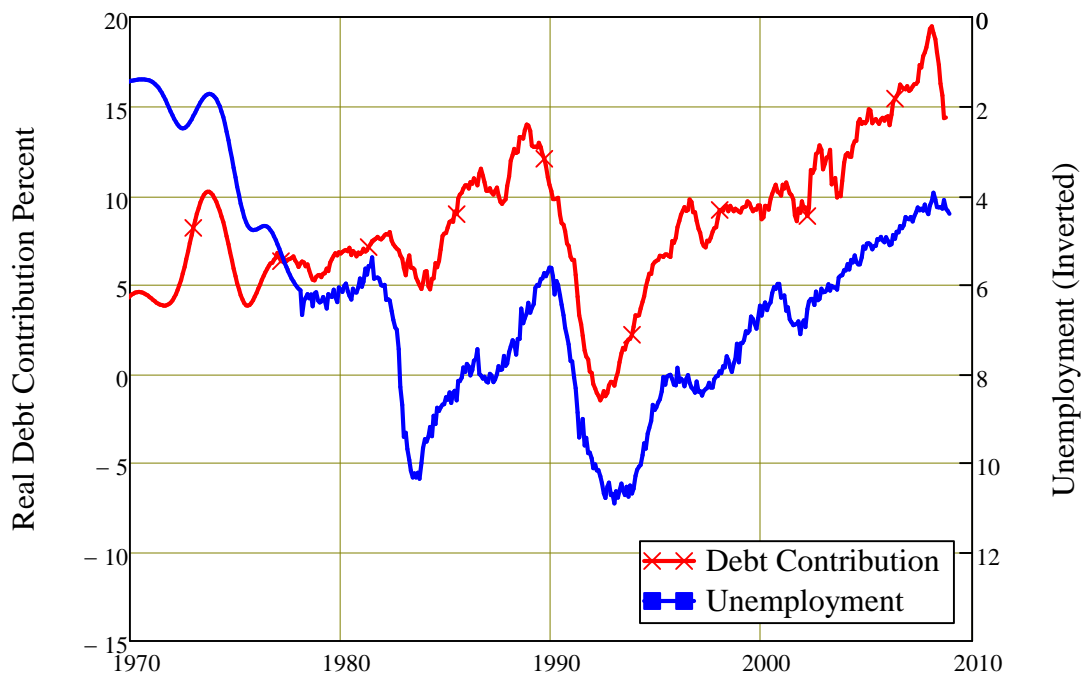
Now, even more so than for the Whitlam Government, the Rudd Government's modest economic plans have been overtaken by financial events that were set in train long before it came to office. There is no prospect that Rudd will be blamed for causing the crisis, since it was already obvious that this was a global crisis that had already started before Rudd took office. But there is a very strong prospect that economic conditions will worsen dramatically on his watch, and the conventional "Keynesian" policies he follows will fail to control the decline--just as the conventional Keynesian policies that Jim Cairns adopted in the 1970s failed to arrest the economic decline back then.



Correlation is not causation of course. But the correlation between changes in debt and unemployment is strikingly visible in the long run plot, and the causal mechanism behind it is simple. Aggregate spending is the sum of nominal GDP plus change in debt, and as debt grows relative to GDP, the dramatic that changes in debt start to outweigh the more gradual changes in GDP in terms of the impact on economic activity. So when debt rises, unemployment falls--and

vice versa.

Debt Contribution and Unemployment



These next two tables put that visual correlation into statistical form. If we look at the whole period from the mid-1960s till now, there is no particular pattern between debt's contribution to demand and unemployment--the simple reason for this being that back in the early 60s' debt's contribution to demand was pretty immaterial: income (GDP) was the source for the vast majority of demand, and the ups and downs of debt were pretty irrelevant. But as debt grew relative to GDP, its ups and downs became more and more significant an influence on overall economic activity--and hence on the unemployment rate.

	0	1	2	3	4	
	"Variable"	"Compared to"	"Start Date"	"End Date"	"Correlation %"	
	1	"Debt % AD"	"Unemp."	1965	2008.75	0.181
	2	"Debt % AD"	"Unemp."	1970	2008.75	-28.406
T1 =	3	"Debt % AD"	"Unemp."	1975	2008.75	-62.779
	4	"Debt % AD"	"Unemp."	1980	2008.75	-85.091
	5	"Debt % AD"	"Unemp."	1985	2008.75	-91.964
	6	"Debt % AD"	"Unemp."	1990	2008.75	-95.604
	7	"Debt % AD"	"Unemp."	1995	2008.75	-92.898
	8	"Debt % AD"	"Unemp."	2000	2008.75	-94.046

As T1 above shows, by the time we hit the mid-1980s--when the debt to GDP ratio was more than twice the sustainable level it had been from 1945-1965--changes in the contribution that debt made to demand accounted for 95% of the variation in unemployment.

The same pattern can be seen in the rolling 5 year correlations shown in Table 2: as time goes on, changes in debt come to swamp changes in output as determinants of economic activity and hence unemployment (the correlations would be higher still if the series were lagged to take account of the fact that unemployment changes direction well after debt does).

	0	1	2	3	4
0	"Variable"	"Compared to"	"Start Date"	"End Date"	"Correlation %"
1	"Debt % AD"	"Unemp."	1965	1970	19.728
2	"Debt % AD"	"Unemp."	1970	1975	17.1
3	"Debt % AD"	"Unemp."	1975	1980	53.664
4	"Debt % AD"	"Unemp."	1980	1985	-74.014
5	"Debt % AD"	"Unemp."	1985	1990	-70.4
6	"Debt % AD"	"Unemp."	1990	1995	-90.674
7	"Debt % AD"	"Unemp."	1995	2000	-58.442
8	"Debt % AD"	"Unemp."	2000	2008.75	-94.046

One apparent paradox is that the changes in debt itself have gotten smaller over time. The 1970s bubble that killed the Whitlam government saw debt grow by 35 percent in one year; but the maximum rate of growth of debt during our current bubble was only 17 percent.

However, the reason for this is that debt is so much greater now than then that even tiny movements in debt now shake the economic house. The 1970s 35 percent debt bubble translated to only an 11 percent rate of increase in the debt to GDP ratio, whereas the 2000's 17 percent bubble drove up the debt to GDP ratio at a maximum rate of 24 percent--because private debt is now 1.65 times GDP.

Debt is truly the elephant in the economic living room, and one that our conventional neoclassical economic managers have ignored as it has grown from Hatari-scale (see http://en.wikipedia.org/wiki/Baby_Elephant_Walk) to that of a raging bull. That bull elephant has now changed direction, and it is only a matter of time before this results in rapidly rising unemployment in Australia.

No more leveraged rescues

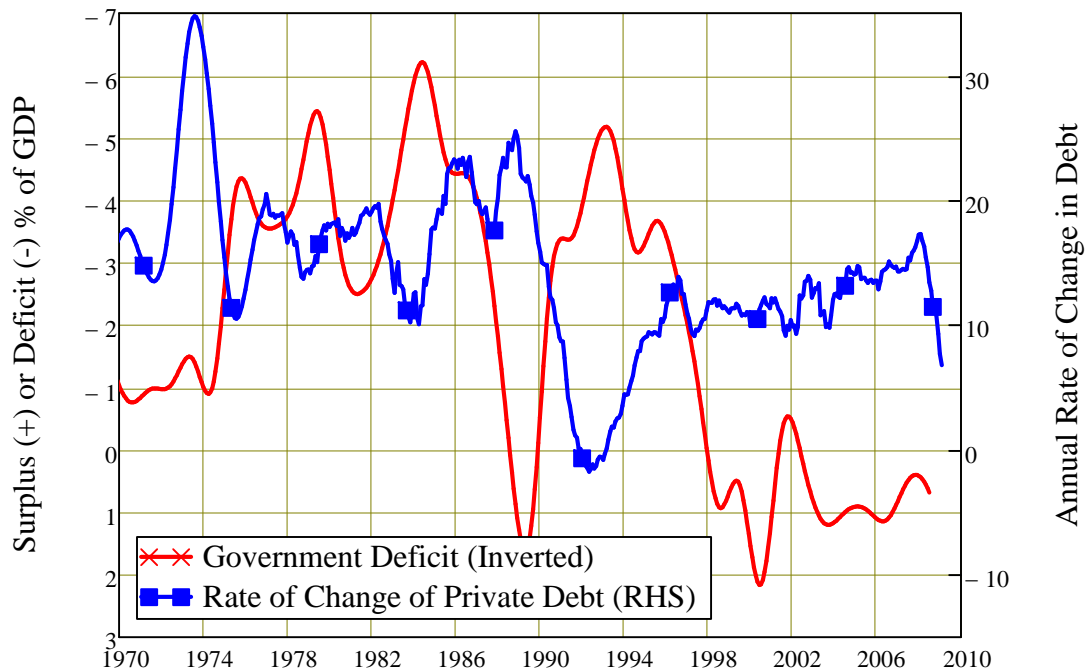
So in one sense, Rudd really is the new Whitlam. His government's economic dilemma was laid down before it came to office, by a debt bubble whose collapse he now has to manage.

This was not even apparent to the Whitlam Government at the time, and it copped the flak for the economic collapse that was in reality beyond its control (and replicated, at slightly different dates, elsewhere around the world). The same could well happen to Rudd.

Certainly the Liberal Opposition is trying to draw parallels between the "irresponsible" spending of the Whitlam Government and the Rudd Government's sudden turnaround from a A\$20 billion budget surplus to a substantial budget deficit. The mud may well stick, but the real reason for the blowout in the government's deficit during a recession is the collapse in the private sector's finances. The mirror-image relationship between changes in the rate of growth of private debt and the government's fiscal balance is striking--and the leading roll that the private sector's behaviour

plays is obvious. Here, as with money creation as I covered in last month's Debtwatch, it is the private sector dog that drives the public sector tail.

The Real Twin Deficits

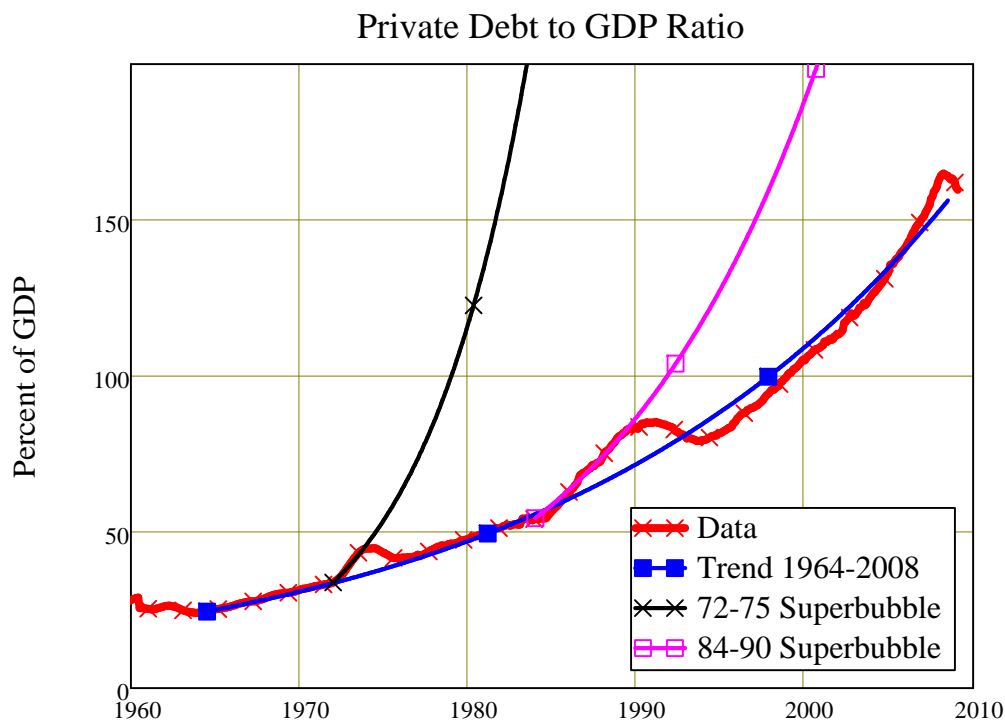


The one advantage for Rudd is that this crisis is so obviously global that he can't be blamed for causing it (though it hasn't stopped some of the usual suspects from claiming that if only Work Choices hadn't been repealed, everything would be hunky dory). But his government will be judged by how well it copes with this crisis that is not of its making.

If it sticks with the current course--trying to spend its way out of trouble--then it will fail, because this time the crisis is too big to be papered over. The earlier economic recoveries after the bursting of the 72-74 and 84-89 super-bubbles only occurred because the private debt engine was restarted.

Both bubbles were clearly unsustainable--as noted above, had the 72 superbubble continued, the debt ratio would now be 10,390% (*i.e.*, private debt would be over 100 times GDP). Even the lesser 1980s superbubble, when the ratio grew at half that rate (7.75% p.a. versus 15.5%) would have resulted in a debt to GDP ratio of 380% today.

But when these earlier bubbles burst, the debt ratio was low enough to make its restarting feasible--with a different group of borrowers, of course. That is no longer possible.



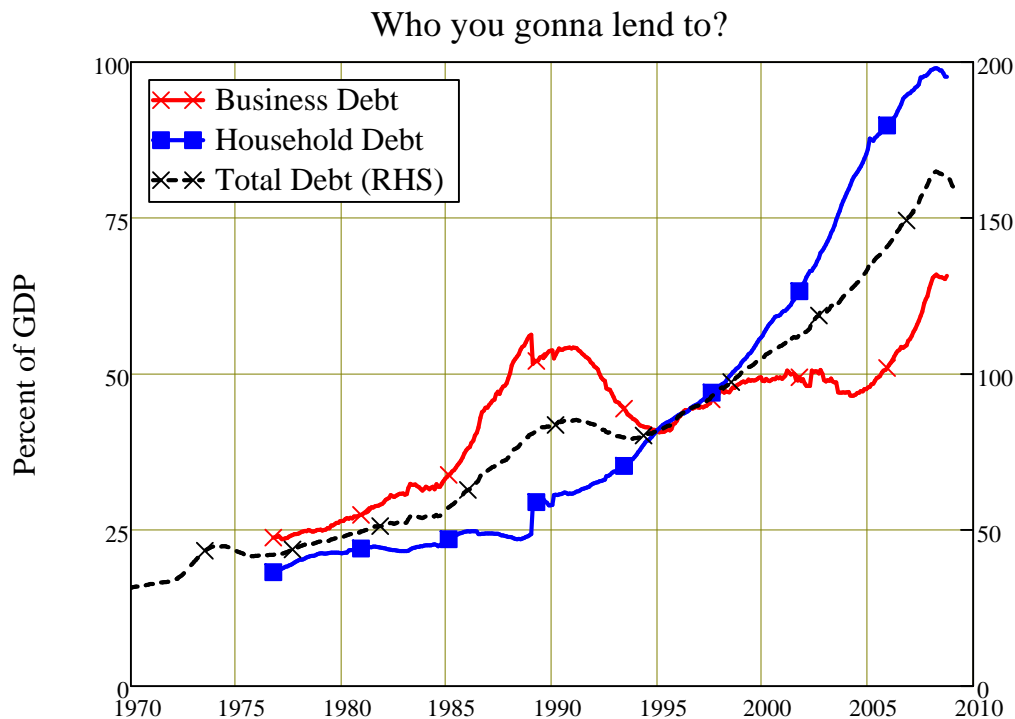
Disaggregated debt data for the 1973 superbubble isn't available--though fairly obviously it financed the Sydney property bubble in the early 1970s associated with the name of Frank Theeman (and on the opposition side, Juanita Nielsen).

The 1984 superbubble was clearly directed at business borrowing--and there the obvious names were Bond, Skase, Connell and so on.

The bubble since 1994 has grown at a mere 4.8% per annum--only slightly faster than the overall growth rate from 1964 of 4.2%--as the household sector was targetted by lenders. The trend in aggregate private sector debt masked a growth in the households debt to GDP ratio of 7% p.a., while business debt actually fell, as a proportion of GDP, from a high of 56% in 1989 to a low of 41% in 1995 (the sudden drop in 1989 and the matching rise in household debt was due to a reclassification of some business debt as private by the ABS in 1989).

However in 2004, business borrowing took off again--largely as a belated response to the China boom, but also partly due to the now defunct private equity bubble--so that by mid-2008, both household and business debt were at historic highs: household debt was five times the level of the mid-1970s, while business debt was almost three times that level.

There is no-one else left to lend to. With both business and households holding historic levels of debt, much of which was borrowed to finance speculation on asset markets that are now collapsing, the trend in debt will be deleveraging, not further gearing up. So the remedies that "worked" in the 1970s and 1990s can't work this time round.



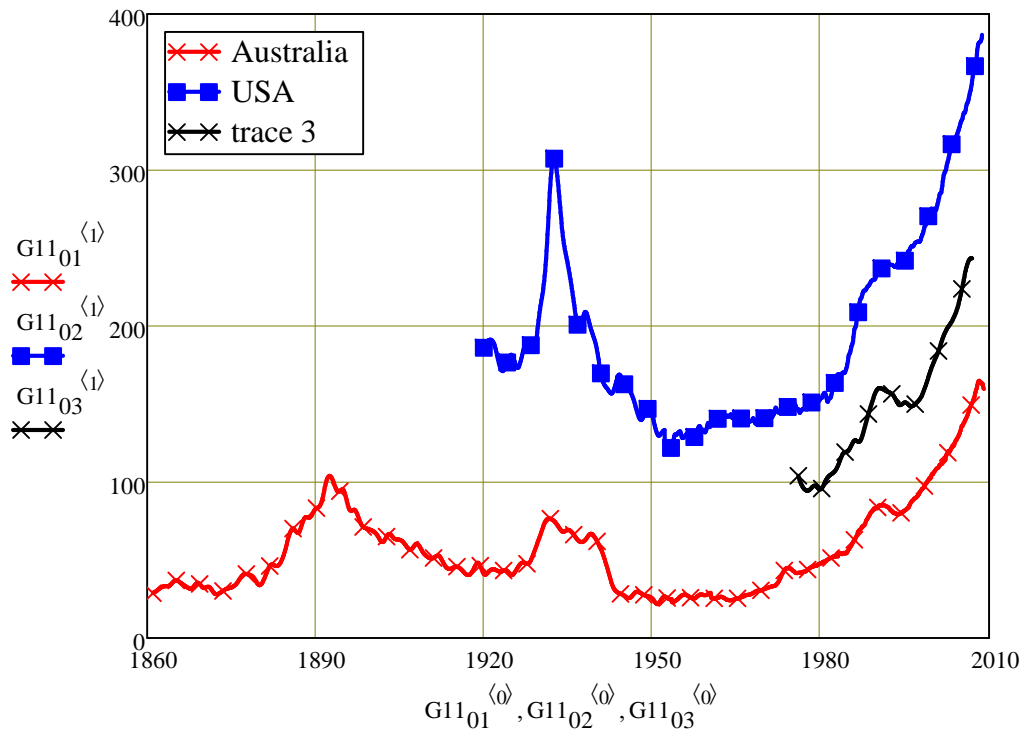
Rudd's A\$42 billion stimulus package will therefore be swamped by private sector de-leveraging. If, for example, the private sector tried to reduce its leverage by a mere 5%, it would take A\$100 billion out of circulation, more than twice as much as Rudd is trying to add to it.

The real test of Rudd's mettle will come when these conventional "Keynesian" policies have been tried and failed several times. Will he continue down that track, or will he do what Niall Ferguson this week called upon governments to do instead: not to increase debt by going into deficit themselves, but to reduce debt by resetting it?

That, ultimately, is the only way out of this crisis. Our illusory prosperity of the last 40 years has been the by-product of an unsustainable growth in debt that has been aided and abetted by well meaning but ill-conceived "rescues" of the financial system from its own folly. All these have really done is encourage it to restart lending after each crisis, each time targetting a less and less likely candidate for leveraged speculation, and each time placing a higher and higher aggregate debt burden on the physical economy.

To state the obvious, though this Debtwatch has been about Australia, the phenomenon itself has been global. The debt ratio in Australia certainly exceeds anything in our economic history--it is 2.5 times as high as during the Great Depression and 2/3rds higher than during the 1890s Depression. The US's debt ratio exceeds its Great Depression peak (which, like ours, was exacerbated by deflation and collapsing output) and is almost twice what it was at the end of 1929; the UK's ratio is 2.5 times what it was just three decades ago. The same pattern is repeated across the OECD.

Though truly long term data is difficult to locate, this is probably the biggest debt bubble in the history of capitalism. If we are going to survive it, we have to reduce debt--and not merely shuffle it from private books to the public purse.



I can't put this argument any better than Niall Ferguson has done (see <http://www.theaustralian.news.com.au/business/story/0,28124,25115869-643,00.html> and <http://www.niallferguson.com/site/FERG/Templates/Home.aspx?pageid=1>), so I will close by quoting him:

There is a better way to go, but it is in the opposite direction. The aim must be not to increase debt but to reduce it. In past debt crises - which usually affected emerging market sovereign debt - this tended to happen in one of two ways.

If, say, Argentina had an excessively large domestic debt, denominated in Argentine currency, it could be inflated away. If it was an external debt, then the government simply defaulted on payments and forced the creditors to accept a rescheduling of debt and principal payments.

Today, Argentina is us. Former investment banks and German universal banks are Argentina. American households are Argentina. But it will not be so easy for us to inflate away our debts. The deflationary pressures unleashed by the financial crisis are too strong (consumer prices in the US have been falling for three consecutive months; the annualised rate of decline for

the last quarter of 2008 was minus 12.7 per cent.)

Nor is default quite the same for banks and households as it is for governments. Bankruptcy can be a complicated business. Understandably, monetary authorities are anxious to avoid mass bankruptcies of banks and households, not least because of the knock-on effects on asset prices of distressed sales of assets.

The solution to the debt crisis is not more debt but less debt... banks that are de facto insolvent need to be restructured, a word that is preferable to the old-fashioned nationalisation. Existing shareholders will have to face that they have lost their money. Too bad; they should have kept a more vigilant eye on the people running their banks...

No doubt those who lose by such measures will not suffer in silence. But the benefits of macro-economic stabilisation will surely outweigh the costs to bank shareholders, bank bondholders and the owners of mortgage-backed securities.

*Americans, Churchill once remarked, will always do the right thing - after they have exhausted all the other alternatives. But if we are still waiting for Keynes to save us when Davos comes around next year, it may well be too late. **Only a Great Restructuring can end the Great Repression. It needs to happen soon.***

Meanwhile, Back in the US of A...

The figures coming out of the USA now are both staggering and entirely predictable. Their debt bubble's burst is further down the track, and the devastation of the economy is evident. The tracks of the debt elephant are obvious (see Tables 3 and 4 below). Unemployment has skyrocketed to 7.2 percent, GDP is now falling at an annualised rate of 6.2 percent, and the US stock market indices are now back to where they were 12 years ago. This is no ordinary crisis--though the Obama Government is still trying conventional means to overcome it.

Debt Contribution and Unemployment, USA



	0	1	2	3	4
	"Variable"	"Compared to"	"Start Date"	"End Date"	"Correlation %"
	"Debt % AD"	"Unemp."	1960	2008.75	-24.657
	"Debt % AD"	"Unemp."	1965	2008.75	-27.275
T3 =	"Debt % AD"	"Unemp."	1970	2008.75	-57.399
	"Debt % AD"	"Unemp."	1975	2008.75	-67.161
	"Debt % AD"	"Unemp."	1980	2008.75	-63.296
	"Debt % AD"	"Unemp."	1985	2008.75	-64.791
	"Debt % AD"	"Unemp."	1990	2008.75	-81.304
	"Debt % AD"	"Unemp."	1995	2008.75	-44.721
	"Debt % AD"	"Unemp."	2000	2008.75	-51.032

	0	1	2	3	4
	"Variable"	"Compared to"	"Start Date"	"End Date"	"Correlation %"
	"Debt % AD"	"Unemp."	1960	1970	-53.17
	"Debt % AD"	"Unemp."	1965	1975	35.09
T4 =	"Debt % AD"	"Unemp."	1970	1980	-43.734
	"Debt % AD"	"Unemp."	1975	1985	-58.768
	"Debt % AD"	"Unemp."	1980	1990	-67.035

6	"Debt % AD"	"Unemp."	1985	1995	-35.619
7	"Debt % AD"	"Unemp."	1990	2000	-95.187
8	"Debt % AD"	"Unemp."	1995	2005	-44.86
9	"Debt % AD"	"Unemp."	2000	2008.75	-51.032

There at least Ferguson gives us some hope. As he reminds us, "Americans, Churchill once remarked, will always do the right thing - after they have exhausted all the other alternatives."

END OF COMMENTARY

Comments on the data

Though there was a slight increase in the rate of growth of debt over the last month, it was still below the rate of growth of nominal GDP--so that the debt to GDP ratio continued to fall from its peak of 165% set in April of 2008 to be more than 5 percent lower now at 159.7%. The danger is that the fall into deflation that has already started in the USA will be replicated here, so that the debt burden will rise as both output and prices fall faster than individuals can reduce their debt levels.

The one component of debt that has fallen consistently for the last six months is personal debt. However at the same time credit card debt is rising. The implication is that, while households are largely unable to service their credit card debt, they are no longer taking out consumer credit from the "Buy now, no interest for 3 years" brigade.

Table One: Aggregated Debt Summary

Table One

	0	1	2
0	"Summary"	"Total Private Debt"	"Including Securities"
1	"Date (levels)"	2009.08	2008.92
2	"Levels (\$m)"	1913679	2043604.49
3	"Change Month \$m"	6753	4994.5
4	"Change Month %"	0.35	0.24
5	"Change Year \$m"	121238	163579.23
6	"Change Year %"	6.76	8.7
D ₁ = 7	"Since 1990"	8.94	8.91
8	"Since 1980"	12.01	12.01
9	"Since 1964"	13.45	13.45
10	"Date (% GDP)"	2009.08	2008.92
11	"As % of GDP"	159.68	173.36
12	"Change Month"	-0.46	-0.59
13	"Change Year"	-2.78	-0.59
14	"Since 1990"	3.11	3.76
15	"Since 1980"	4.15	

19	Since 1990	11.9	...
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Table Two: Disaggregated Debt Summary

Table Two

	0	1	2	3	4
0	"Detail"	"Business"	"Inc. Securities"	"Mortgage"	"Personal"
1	"Levels (\$m)"	767925	905096.49	1000470	145281
2	"Change Mth \$m"	2323	1982.5	4791	-363
3	"Change Mth %"	0.3	0.22	0.48	-0.25
4	"Change Yr \$m"	2323	1982.5	75822	-8559
5	"Change Yr %"	7.56	10.43	8.2	-5.56
D ₂ = 6	"Since 1990"	5.61	6.92	14.77	5.8
7	"Since 1980"	10.71	11.46	13.96	10.4
8	"Since 1976"	11.2	11.87	14.23	11.15
9	"As % of GDP"	64.05	76.78	83.45	12.12
10	"Change month"	-0.54	-0.61	-0.36	-1.09
11	"Change year"	-2.09	0.99	-1.51	-14.04
12	"Since 1990"	-0.37	1.12	9.21	-0.18
13	"Since 1980"	3.04	3.79	6.04	2.61
14	"Since 1976"	3.09	3.75	5.83	2.97





Growth of Debt (including Securities) & GDP

