

## Submission to the House of Representatives Economics Committee Inquiry into Home Loan Lending Practices and Processes

### 1. *To what extent have credit standards declined in Australia in recent years?*

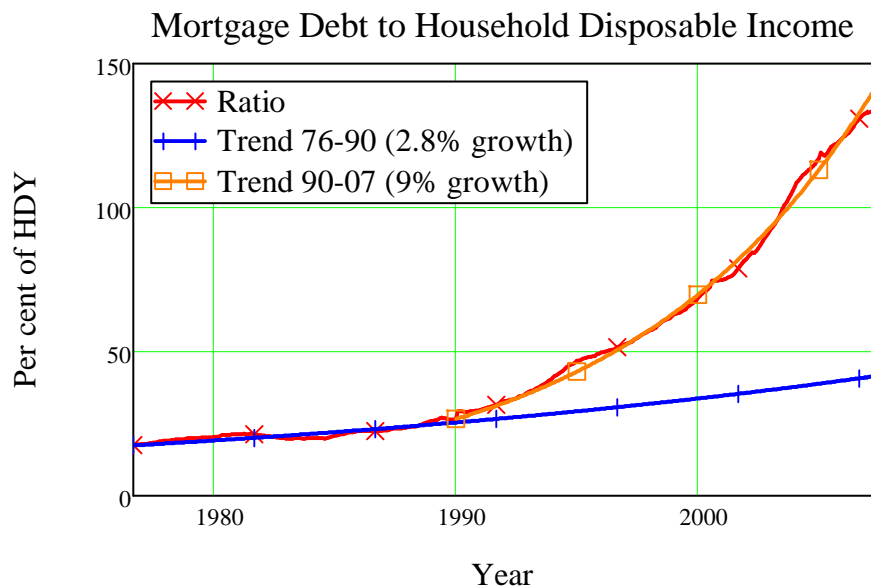
From a long term perspective, credit standards in Australia have been declining steadily since mid-1964. However with a shorter time horizon, there certainly has been a substantial acceleration in the rate of decline of credit standards in lending to households for mortgages and credit cards.

These declines are obvious in the data comparing aggregate mortgage and personal debt levels to household disposable income (HDI). Between 1976 and 1990, the ratio of mortgage debt to HDI grew at 2.8% per annum; from 1990, the rate of growth more than tripled to 9.65% per annum.

The mortgage to HDI ratio between 1976 and 1990 rose from 17.5% to 26.5%, which gave no cause for alarm (the relative increase in interest rates across the same period was far higher). However, the increase between 1990 and today was from 26.5% to 134%--a more than fivefold rise, and alarming in anyone's books. Today's ratio is over three times what it would have been had the pre-1990 trend continued (Chart A; all charts are produced using data from the RBA Bulletin Statistical Tables; the Sheet used are referenced with the charts below).

#### Chart A

▢ Mortgage Debt to Household Disposable Income (Sheets D02 & G12)

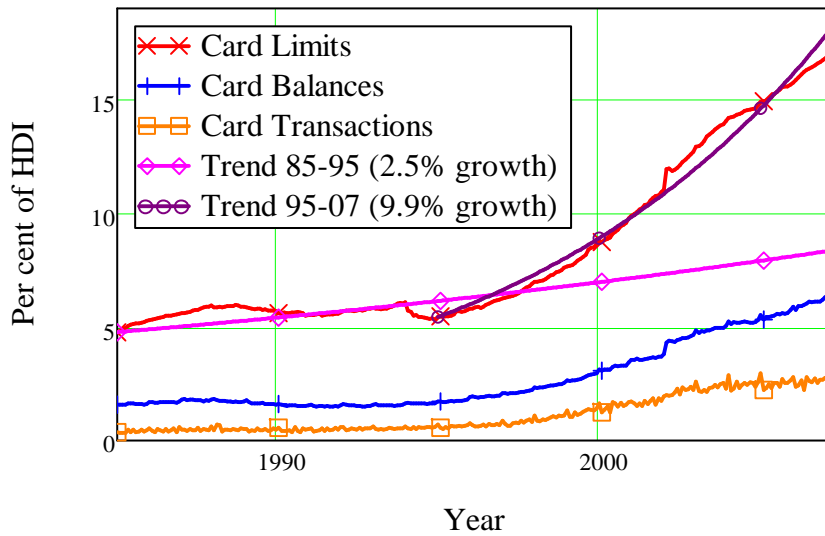


A similar story applies for credit cards, where the deterioration began later, but was just as marked. After showing only a small upward trend between 1985 and 1995 (of no more than 2.5% p.a., and with a statistically insignificant correlation), credit card limits, balances and transactions all began to rise relative to HDI in 1995 at about 10% per annum (with a highly significant correlation). The current levels are more than twice what would have applied with a continuation of the pre-1995 trend (Chart B).

▢ Credit Card Data (Sheets C01 & G12)

**Chart B**

**Credit Cards To Household Disposable Income**



Given these accelerations in the trend rates of growth, one could say that, as a crude statistical measure, lending standards have deteriorated more than threefold since the 1990s.

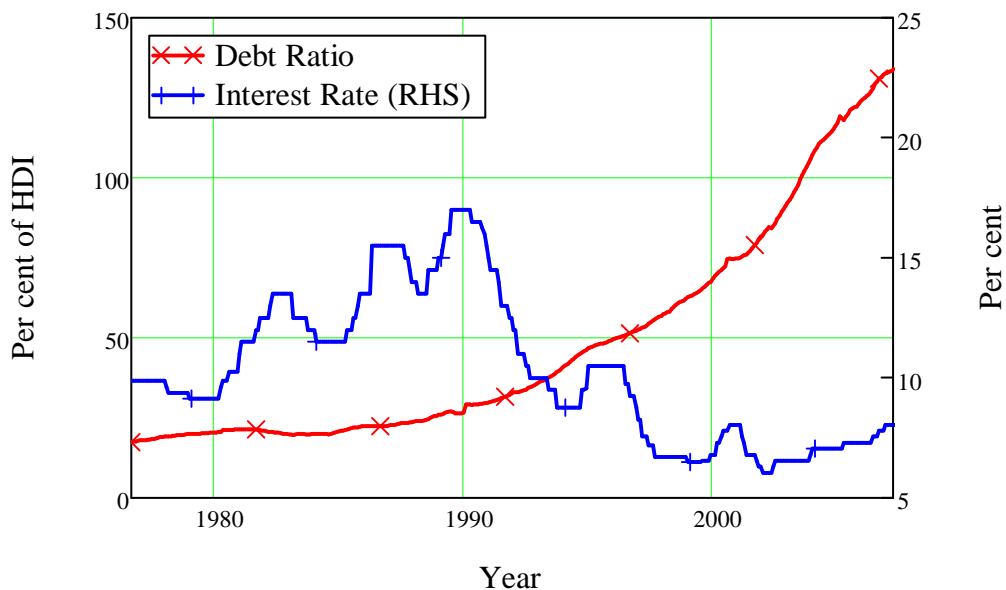
From an economic point of view, the deterioration is worse still. Conventional economic theory sees all economic data as the product of the optimising behavior of rational agents, and from this perspective, these growth rates of debt to income should not even exist. At the very worst, the ratios should rise and fall in counterpoint to changes in interest rates, thus keeping the debt repayment burden constant as a proportion of income. Clearly this has not been the case.

Though the take-off in mortgage debt did coincide with a period of rapidly falling rates, the growth rate continued unabated once rates stabilised in 1997, and has persisted even with rising mortgage interest rates since 2002 (Chart C).

▢ Mortgage Debt & Interest Rates (Sheets D02, G12 & F05)

**Chart C**

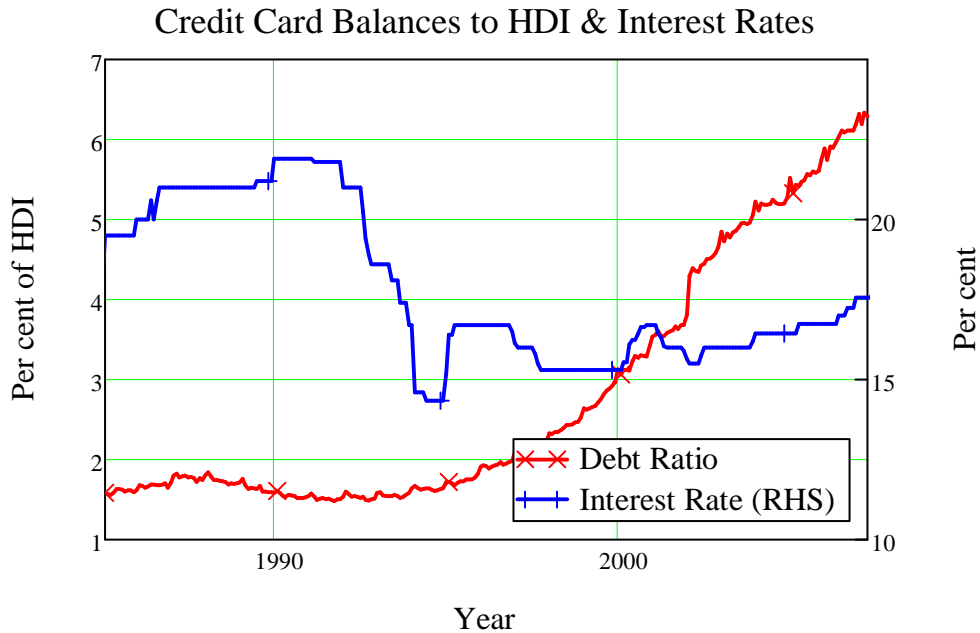
**Mortgage Debt to HDI & Interest Rates**



The picture is even more stark with credit card debt. Credit card balances remained static as a proportion of HDI between 1990 and 1995, even though rates fell substantially across those years--from 22 per cent to under 15 per cent. The increase in the credit card balance to HDI ratio coincided with an *increase* in interest rates. Rates are now about 17.5 per cent, well above the 1995 low--and yet balances have more than tripled as a proportion of disposable income (Chart D).

**Chart D**

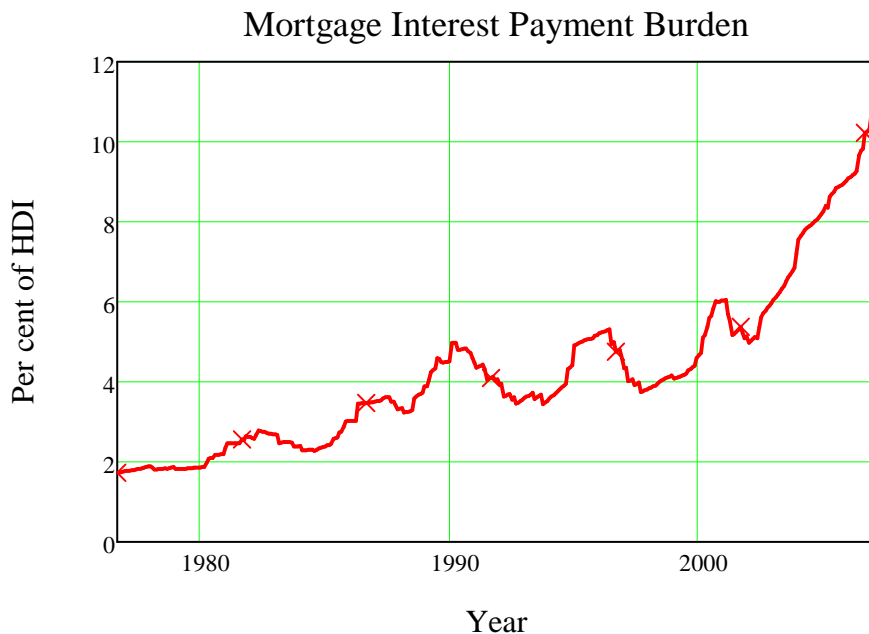
▢ Credit Card Usage & Interest Rates (Sheets C01, G12 & F05)



As a result, the proportion of household disposable income going to service debt has reached historic highs. Mortgage interest payments now consume 11 per cent of disposable income--compared to 5 per cent in 1990 (Chart E; but see also Chart G). Credit card interest payments have risen even more sharply, from the historic low of less than 1/4 of one per cent of disposable income in 1995, to well over 1 per cent now (Chart F).

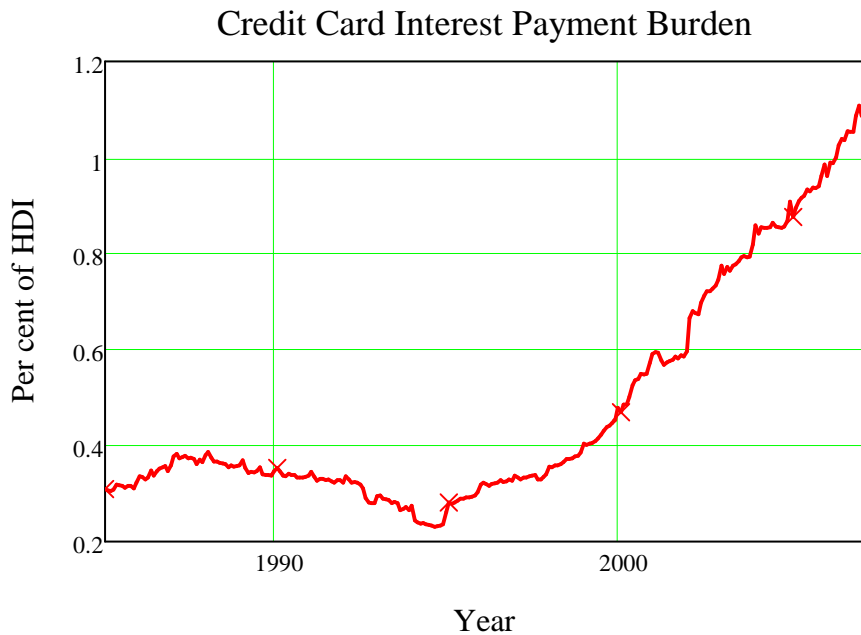
▢ Mortgage Debt Repayment Burden (Sheets D02, G12 & F05)

**Chart E**



**Chart F**

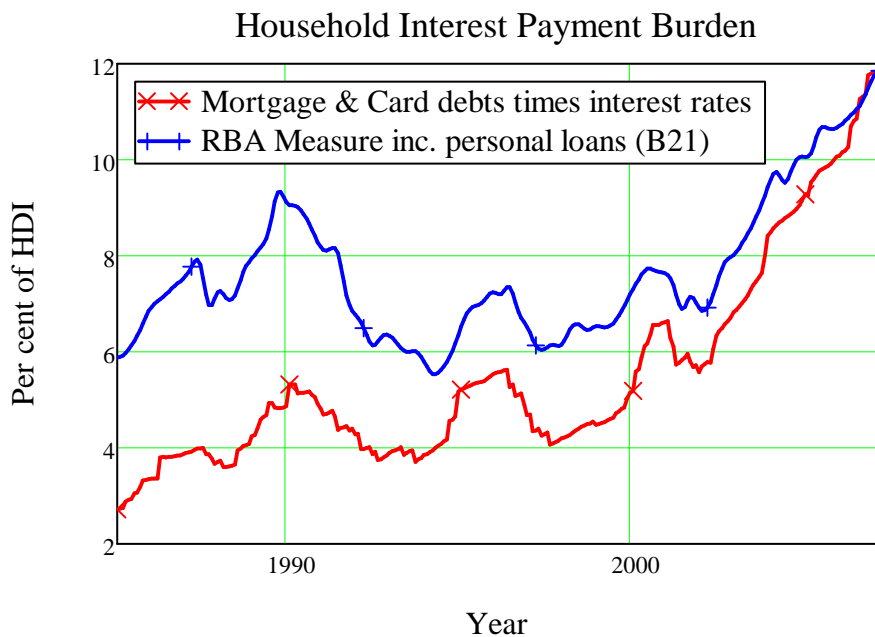
▣ Credit Card Debt Repayment Burden (Sheets C01, G12 & F05)



In aggregate terms, household interest payments now exceed the levels that applied during the 1990s, and are easily the highest they have been in post-WWII economic history (Chart G; the two measures there are nearly identical now, but differ substantially historically: the RBA's calculation of the total interest burden on households [B21] and a figure derived by multiplying mortgage and credit card debt levels by the relevant interest rates [C01, G12 & F05]; the discrepancy reflects the wider definition of personal debt in the B21 series, and a reclassification of a substantial proportion of business debt as personal debt in late 1989).

▣ Credit Card Debt Repayment Burden (Sheets B21, C01, D01, G12 & F05)

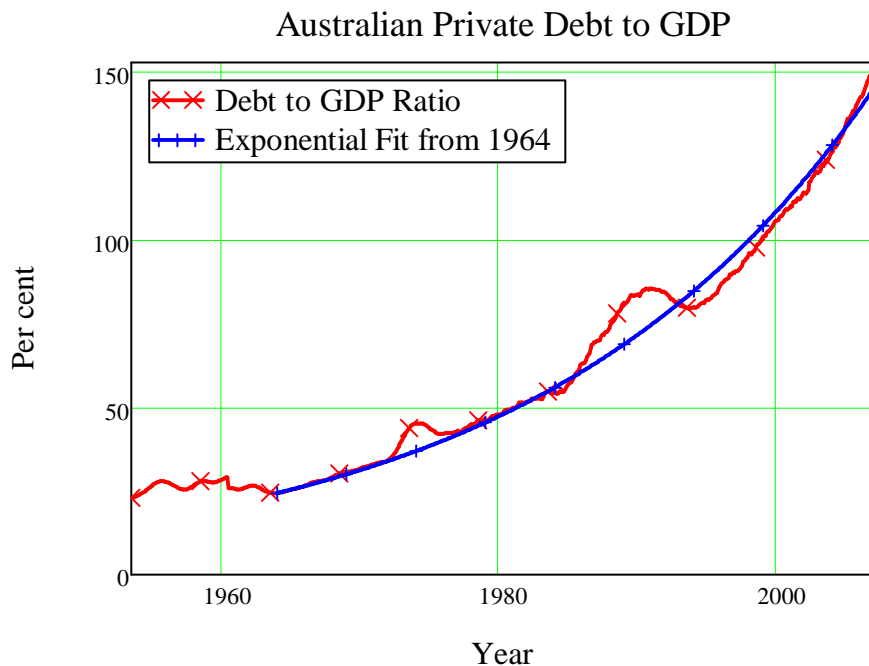
**Chart G**



Though the deterioration in lending standards to household has been recent and marked, from another perspective, this is just a continuation of a trend of deteriorating credit standards--in the sense of a rising ratio of all private debt to income--that dates back till 1964. The private debt to GDP ratio has been growing at 4.16% per annum for over 43 years--and the correlation of a simple exponential fit with the data is a staggering 99.15% (Chart H). Clearly this is an unsustainable trend, and therefore economic policy makers must (a) work out what has caused it and (b) prepare for its reversal.

**Chart H**

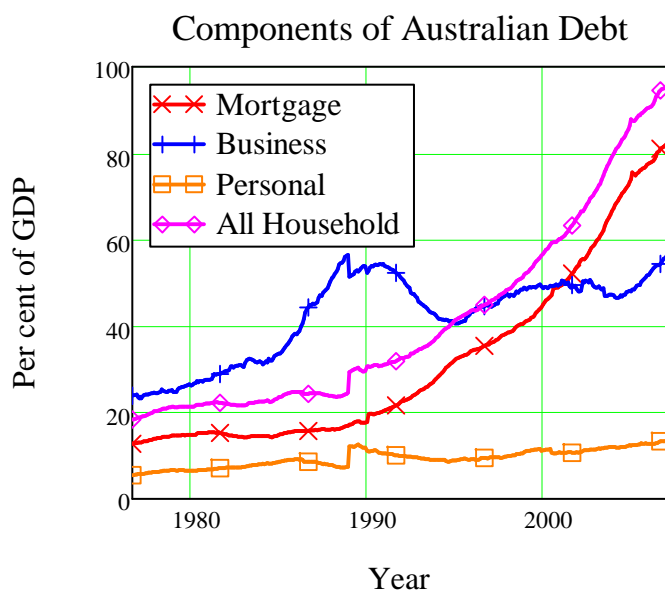
▢ Debt to GDP Regression (Sheets D02 & G12)



However, the components of private debt--business, mortgage and personal loans--show no such clear-cut long-term correlations (Chart I)--an issue I return to under 4 below.

▢ Debt Components to GDP (Sheets D02 & G12)

**Chart I**



**2. Have declining credit standards caused an increase in the number of loans in arrears and the number of repossessions?**

Others at this roundtable are better placed to answer this question than I, and I defer to them here.

**3. Are borrowers in financial difficulty being treated appropriately by lenders?**

Likewise, others are better placed to answer this question than I.

**4. Are declining credit standards likely to have any long-term implications the Australian financial system?**

I believe that this decline in credit standards has implications for the economy in general, as well as for the financial system in isolation. I will concentrate on the economic implications first.

**Economic Implications**

The key point is that the trend rate of growth in private debt is unsustainable: at some point the trend must reverse. If it did not, then at some point interest payments on debt would consume all of Australia's GDP (2040, on current trends and at current interest rates).

Of course, a reversal has to occur long before that point is reached. The private debt to GDP ratio must at the very least stabilise, and given the magnitude of debt today, this has serious implications for economic activity in Australia.

While I can't say when the ratio will stabilise, I can give you some idea of the impact this will have on the economy when it does happen.

Firstly, changes in the debt to GDP ratio have historically been strongly coincident with changes in real output (Chart J--notice, in particular, the 1990 downturn).

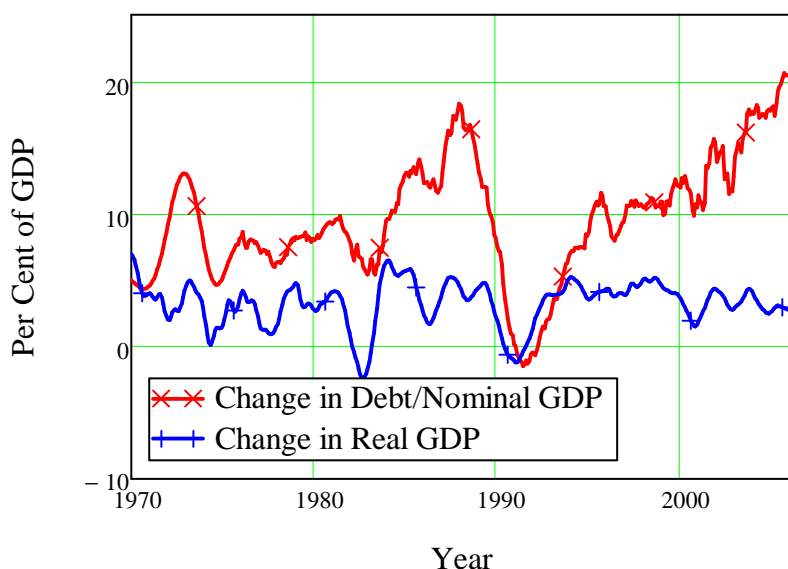
Secondly, as is also evident from Chart J, changes in debt are now substantially larger than changes in output (since private debt is now more than one and a half times the size of nominal GDP). To give some idea of the magnitudes involved, last year, nominal GDP rose by \$74 billion, whereas debt grew by \$200 billion. The depressing impact of a fall in debt on the economy will therefore be much stronger now than it was in the past.

At the depth of the 1990s recession, debt fell at a maximum rate of 1.76 per cent per annum: this translated into a 1.49 per cent fall relative to GDP (since at the time debt was equivalent to 85 per cent of GDP). A similar rate of decline of debt today would be equivalent to a 2.7 per cent fall relative to GDP, since the debt to GDP ratio now exceeds 150 per cent.

▣ Annual Change in Debt & Real GDP (Sheets D02, G10 & G12)

**Chart J**

**Change in Debt & Real GDP**



Thirdly, at the aggregate level, net spending in the economy--on both commodities and assets--is the sum of income plus increase in debt. We can therefore estimate the contribution that growth in debt is making to aggregate spending, by dividing the annual change in debt by the sum of GDP plus change in debt (Chart K). Increasing private debt is now financing 17 per cent of aggregate spending--its highest level in history. This implies that, if debt were to stop growing today, aggregate spending would drop by 17 per cent.

This may seem alarmist, but past history implies that it is not. Notice that debt's contribution to aggregate spending in Australia peaked at 15.4 per cent in November 1987, and then plunged to a low of minus 1.5 per cent in May 1991. The period during which the rate of growth of debt fell below the rate of growth in output coincides neatly with "the recession we had to have".

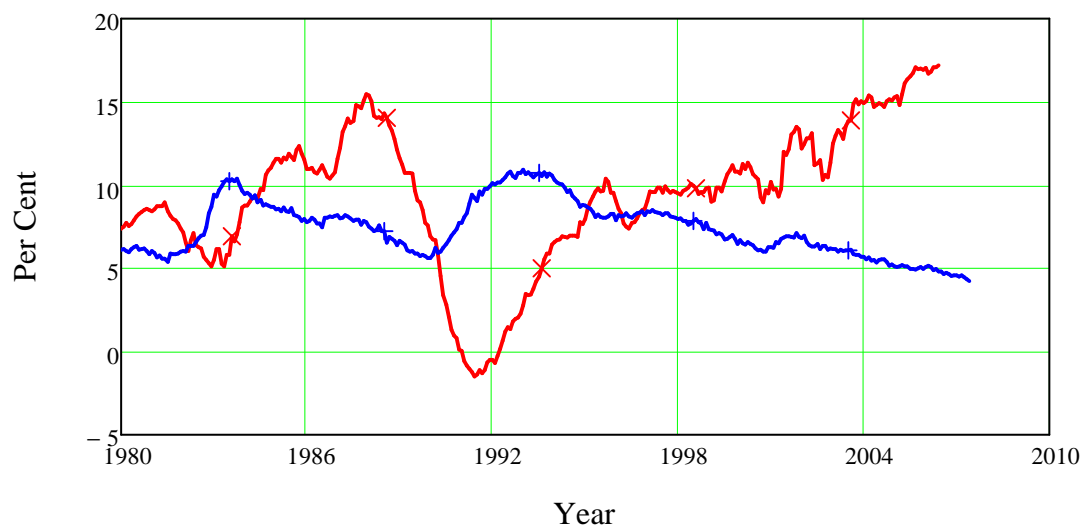
I therefore believe that at some point the ratio of debt to GDP must at least stabilise, and that when it does, the economy will go into recession--unless a substantial external stimulus counteracts the depressing impact of a debt correction.

When this happens, the government will inevitably have to go from running surpluses to running deficits. This is partly because it will have no choice--receipts will fall and social security expenditures rise. But it is also a necessary part of repairing private balance sheets, since the cash flow from government expenditure will in part enable debts to be repaid--when the alternative for many borrowers will be bankruptcy.

▢ Unemployment & Debt (Sheets D02, G12 & G07)

### Chart K

Contribution of Change in Debt to Demand & Unemployment



### Financial Implications

The implications for our financial system are that we have reached what has long been regarded as a cyclical trend with an upward bias in asset prices, and in particular housing, has come to an end. The trend has been financed by rising debt levels compared to income, and we have reached a level where it is simply not possible to contemplate further relative increases in debt.

The general manager of Australian Property Monitors, Michael McNamara, coined the phrase "peak debt" to describe this proposition, and I believe he is correct: one way or the other, debt levels have to fall relative to income.

We have reached this turning point partly because we have misunderstood the nature of credit money. Though economic textbooks still teach that the money supply is controlled by the Reserve Bank, Central Banks throughout the world now concur that they do not control the money supply: their powers are limited to setting the short term rate of interest. The Reserve Bank is quite explicit about this:

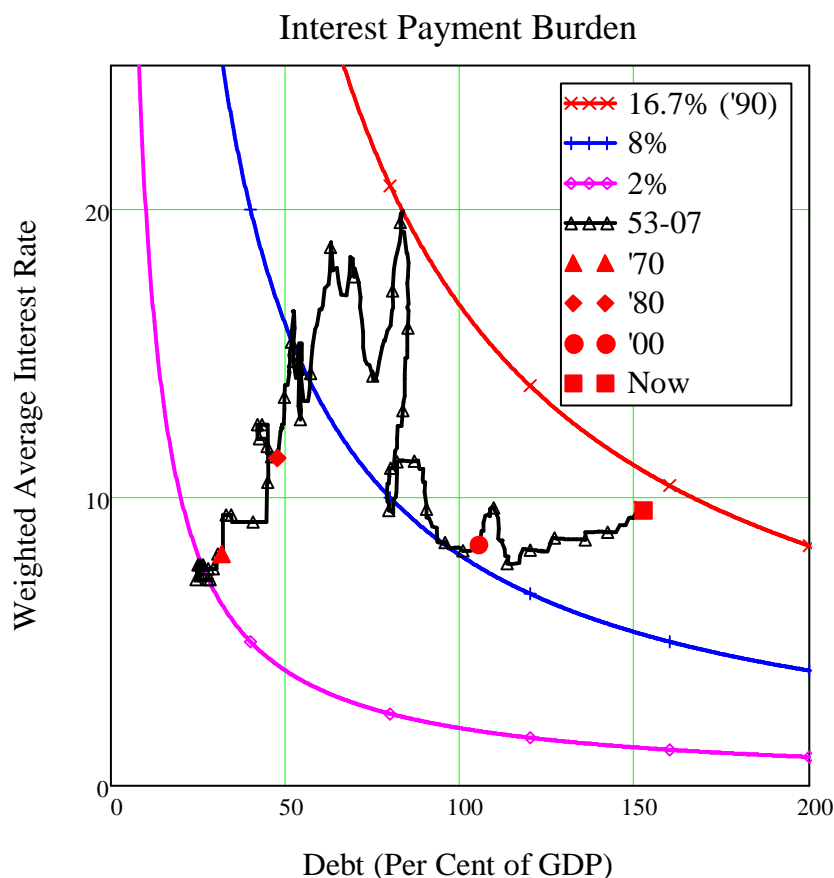
"The Reserve bank has no prescribed target for the level of settlement balances [cash], supplying whatever amount is needed to keep the cash rate near the target (RBA, "The Reserve Bank's Open Market Operations" *Reserve Bank of Australia Bulletin*, June 2003, p. 4).

This means that the supply of credit-based money--and hence debt--is "endogenous". However, while Central Banks admit the endogeneity of money from a practical and policy point of view, they have not yet comprehended what this means in terms of the growth of debt. The Reserve had the hope that the private sector would generate an appropriate amount of credit-created money--the classic belief that, given a deregulated market, the amount supplied would be determined by the balance of supply and demand.

Clearly this has not been the case: rather than reaching an equilibrium, we have substantially overshot the level of debt that our economy can support (Chart L, which shows that the interest payment burden on the economy is approaching the peak levels experienced prior to the 1990s recession, despite a halving of interest rates since then).

▢ Debt, GDP & Interest Rates (Shees D02, G12, F05)

**Chart L**



To understand why this has happened, we need to truly appreciate what it means to say that the money supply, and hence the level of private debt, is endogenous. Yet Central Banks the world over continue to use economic models that ignore debt--the RBA's two in-house developed economic models do not have debt as an argument (or the quantity of money, for that matter).

Using a simple model of endogenous money creation, it is possible to show that banks (the "supply side" in the credit creation process) have an inducement to produce as much credit as borrowers demand, and to also have as little of that debt repaid as possible: there is no rising cost of supply--as in conventional markets--that will ultimately choke off supply. You can't rely on the usual "laws of the market" to reach an equilibrium in the provision of debt, because these laws don't apply to the provision of credit. Credit providers will continue providing credit until an economic crisis ensures that either they stop lending, or borrowers stop borrowing, or both.



The fact that aggregate debt has clearly grown exponentially since 1964, while the breakdowns into business, mortgage and private debt do not display such an obvious trend over the longer term, is evidence that this is a "push" problem of credit providers actively seeking avenues to market debt: as soon as one avenue reaches exhaustion, another one is sought. This might imply that "supply-side" controls should be imposed; however, the abject failure of monetary targeting in the 1980s, and the endogenous nature of credit-money creation, mean that direct attempts to control the supply of credit are likely to fail.

The only way to prevent this boom-bust cycle is to remove the incentives that encourage borrowers to continue borrowing: even if lenders are willing to lend, they cannot do so without willing borrowers. The chief incentive that leads borrowers into taking on excessive debt is the enticement to speculate on asset price appreciation: to borrow money on the expectation of selling an asset on a rising market.

This enticement is amplified by the favourable treatment of capital gains from speculation--as opposed to investment--in the Australian financial system. This has to be reformed investment must be distinguished from speculation. Negative gearing and capital gains concessions should only be available for new houses and initial capital raisings--and not for purchases of either houses or shares on the secondary markets.

*Steve Keen*

*Associate Professor of Economics & Finance*

*University of Western Sydney*

*Locked Bag 1797 Penrith 1797*

*s.keen@uws.edu.au*

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