

REAL WORLD ECONOMICS: Disequilibrium and Debt

I have absolutely no reason to doubt Michael Keating's sincerity in his New Matilda essay "REAL WORLD ECONOMICS: Competition and Cohesion". In fact, I am confident that he sincerely believes that his advice will lead to a better Australia.

What I dispute is that his essay has any substantive connection with the real world.

Michael may well take affront at that, and assert that his policy recommendations are based on well understood economic principles. Again, I don't dispute that: what I contend instead, is that those "economic principles" are in fact wrong.

There are many reasons why this is so, as I explained in *Debunking Economics*. The root problem with conventional (or "neoclassical") economic theory is the concept of equilibrium. When this school of thought originated in the late 19th century, the assumption that economic systems were in equilibrium made economic modelling possible, when the alternative of dynamic analysis seemed just too difficult.

No such problem exists today, but the concept of equilibrium has become such a core belief that economists are often unaware that there is any other way of thinking. They also see equilibrium in the real world, even when there are clearly disequilibrium processes at work.

This is why Michael's conventional economic advice is so dangerous today. There is a clear, disequilibrium process going on, which can only be explained by dynamic analysis, and it undermines two key aspects of his advice: the proposition that "the principle risk in the short-term is inflation"; and the assertion that good economic management requires "a commitment to keep the Commonwealth Budget in surplus over the course of the economic cycle".¹

Inflation or Debt?

Like most economists, Michael Keating seems to believe that inflation is always and everywhere a bad thing. One obvious exception to this rule, however, is when the economy is crippled by an excessive level of debt. Then, the economy can suffer from a "vicious circle" of debt and deflation, with falling prices actually increasing the real burden of debt, further pushing firms and individuals towards bankruptcy.

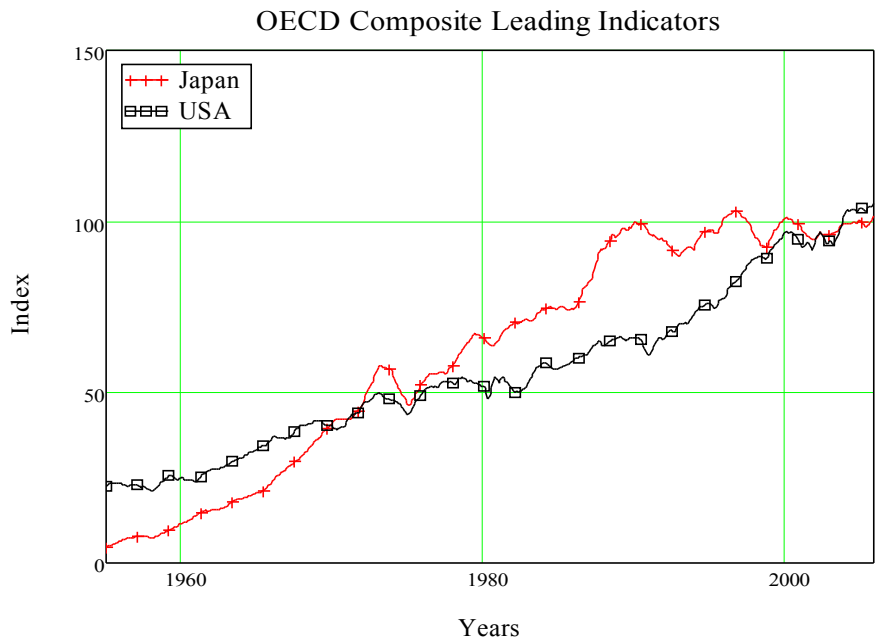
This was Irving Fisher's explanation for the Great Depression, and disequilibrium played a key role in his thinking. It was, he argued, as absurd to assume that key economic variables were always at their equilibrium values, as it was "to assume that the Atlantic Ocean can ever be without a wave" (Fisher 1933, p. 339), and he argued that the Great Depression was caused by the confluence of two disequilibria: "over-indebtedness to start with and deflation following soon after" (p. 341). The combination of too much debt and falling prices locked the global economy—and America and Australia in particular—into ten years of economic misery that was only terminated by the Second World War.

Most economists are confident that this historic tragedy could never repeat itself—and they tend to blame the government for causing it by "not printing enough money". But there are good reasons to argue that Japan fell into a Debt-Deflation when its Bubble Economy collapsed in 1990. The Japanese economy then spent 15 years in the doldrums, as can be seen from the OECD's Composite Leading Indicators (*CLI*).

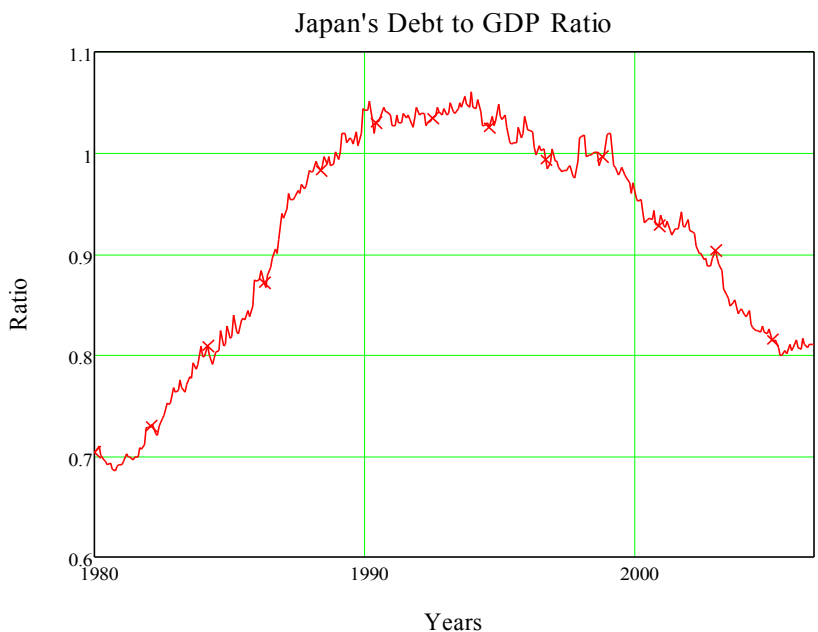
For 35 years, Japan was the "miracle economy": from a position where, in 1955, it was just a fifth of the USA's level on the *CLI* scale, by 1990 it was one and a half times the USA's score. Then

¹ His advocacy of competition policy is a separate issue that I will discuss in a later article.

it hit the wall: Japan's ranking on the *CLI* went nowhere for the next fifteen years, while the USA gradually moved forward, and overtook Japan once more in 2002.



Japan was crippled by debt: the enormous sums that had been borrowed to finance speculation on the Nikkei, and the Tokyo real estate, brought the economy to a standstill. Not until 2005 had debt had been sufficiently reduced to enable the economy to once again start to grow.



Part of the reason for Japan's extended period of economic misery was its low to negative rate of inflation. Inflation was below 3 per cent for almost all of the 1990s and early 21st century; from 1994-96 and again from mid-1998 till 2005, it was actually below zero. As a result, even though the Japanese central bank reduced official interest rates to zero, the market rate of interest remained well above zero—and Japanese companies were forced to devote profits to repaying interest bills, rather than to investing.

Japan went from being inflation-shy to actually wanting to cause inflation, and it attempted to do

so by following conventional economic advice that inflation can be caused by government deficits, and—economic sin of sins!—“printing money”. During the 1990s, the Japanese government ran deficits equivalent to more than 6 per cent of GDP—not a trade deficit, a government deficit: an excess of government spending over taxation. Surely that would have done the trick.

It didn't. Japan is still running the second highest government deficit as a proportion of GDP in the OECD (the Czech Republic takes first place)—but inflation has remained stubbornly stuck on or near zero.

Printing money also had no effect. In one year, the government engineered an increase in M_1 —the segment of the money supply more directly under its control—by over 27 per cent. Inflation remained negative that year: even “printing money” didn't cause inflation.

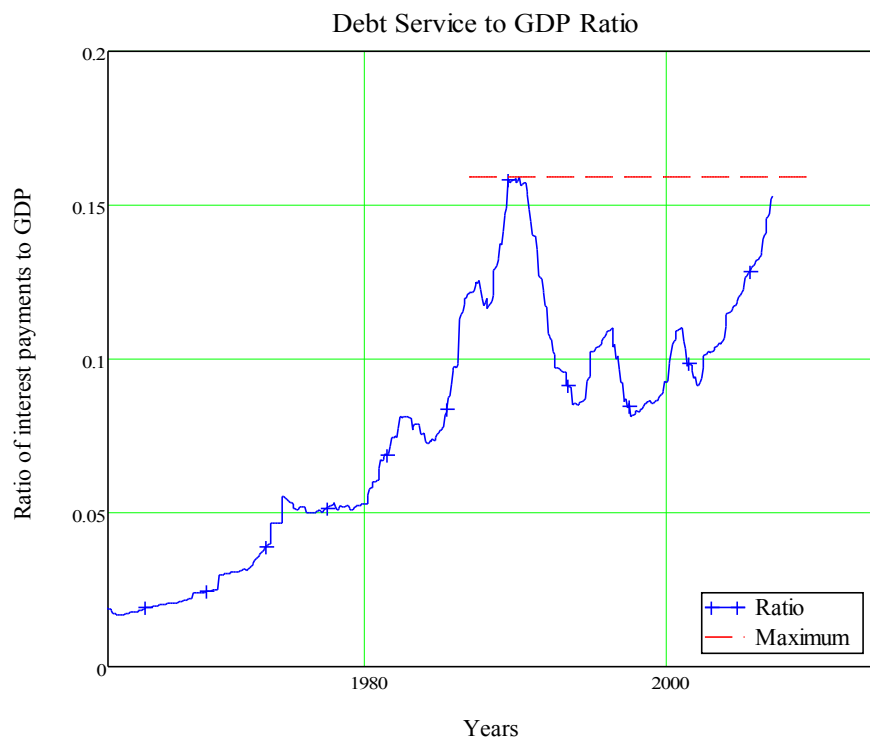
But surely competitive, micro-economically reformed Australia doesn't need to think about causing inflation. We couldn't be in an analogous situation to Japan in 1990, could we?

No, we're not—we're in a much worse position, but this has completely escaped the attention of inflation-obsessed conventional economists. Part of the reason why they have been blindsided by this development is the obsession with equilibrium, and the belief that market systems always tend towards equilibrium. “Seeing” the economy through the filter of their model, the only disequilibrium process they can comprehend is inflation—and that is caused, they claim, by non-market interventions: trade unions, and profligate governments that run deficit budgets and practice irresponsible monetary policies.

There are many signs of disequilibrium processes (which researchers in other disciplines are much more used to searching for than are economists— have you heard of global warming?); one of the clearest is growth in a variable that, in equilibrium, should not be changing much at all.

One that fits the bill is the debt servicing burden: the ratio of interest payments to income. If the economy were in equilibrium, then this ratio should be roughly constant over time.² As the next chart shows, this ratio has been in anything but equilibrium—it has risen from trivial levels of 1.9 per cent in the 1960s to an all-time high of 15.9% in 1990, and at 15.3% today it is again toying with those maximum levels.

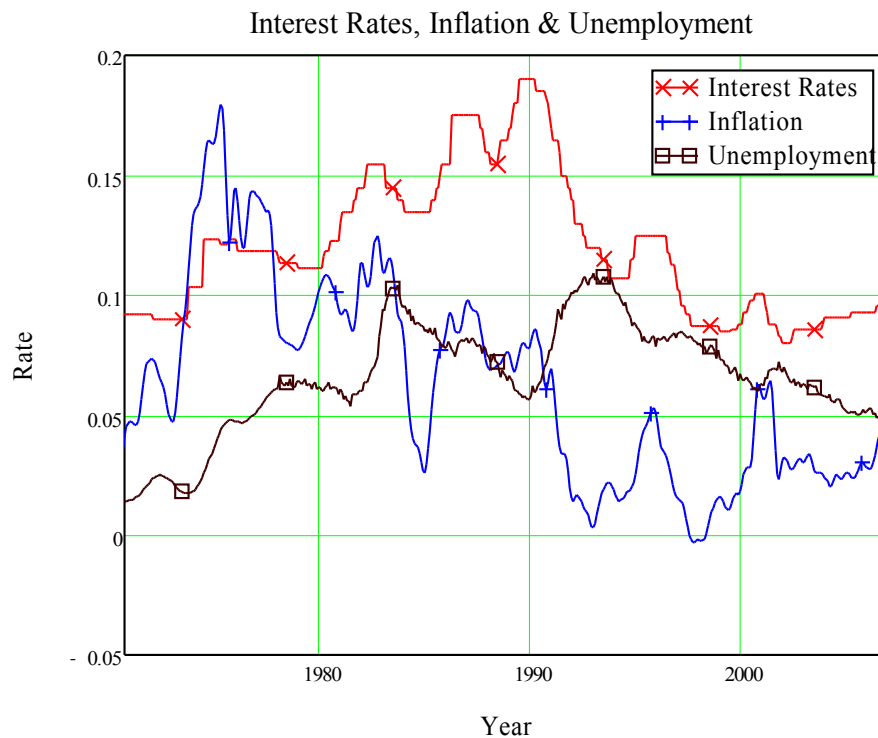
2 In a complete model it might need to be augmented with some measure of the assets to liabilities ratio, but this ratio should also be stable in equilibrium.



Of course, this variable reflects both market activity, and the non-market activity of the RBA (and prior to the establishment of RBA independence, the government) manipulating interest rates in order to control economic activity, and in particular, inflation.³ If we break this composite variable into its two constituents—interest rates on the one hand, private debt levels on the other—we can more clearly delineate non-market from market dynamics.

The former series tracks the blowout in interest rates as our economic managers tried to control inflation during the “stagflation” of the 1970s, then they tried to put the brakes on the runaway speculative bubble of the 1980s, and their attempts to revive the economy when it plunged into “the recession we had to have” in 1990.

³ In contrast to his attitude to most non-market interventions, Michael clearly favours this intervention, and he's at one here with most neoclassical economists. Partly this reflects the fact that economists are in charge of setting this rate, they believe they know how the economy works. In particular, they believe that varying the rate of interest helps control inflation, which itself is caused by undesirable non-market interventions. Some adherents to the Austrian school of economics—which is a relative of neoclassical economics, but which spurns the neoclassical obsession with equilibrium—oppose even this non-market intervention, and argue that we should let the market set interest rates as well. I disagree with both of them: I don't believe that either School understands the economy (though the Neoclassicals are further from the mark than the Austrians), and in particular, I argue that the role of interest rates is much more complex than either School believes.

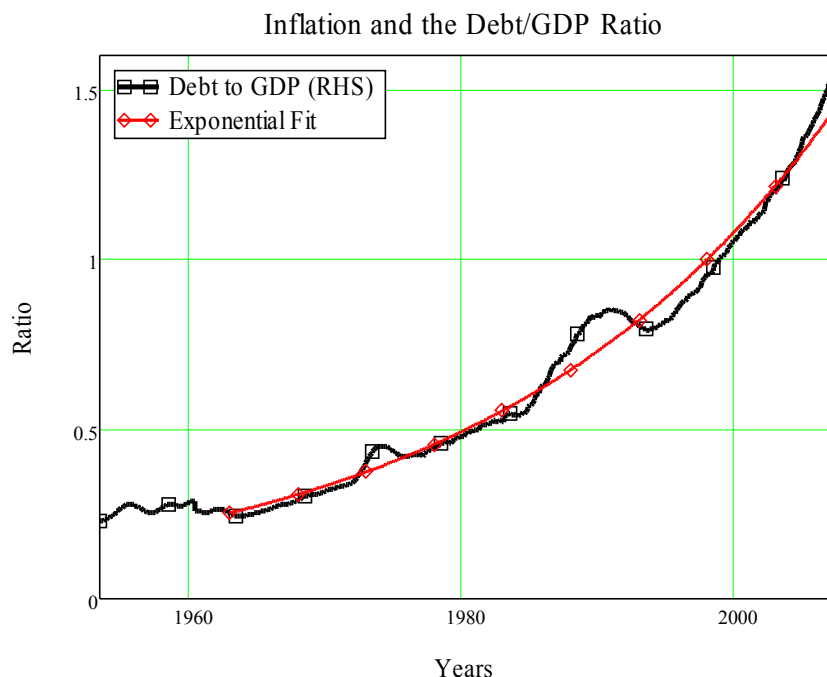


The latter exposes the driving disequilibrium process in the Australian economy—and indeed the world economy—that has escaped the attention of our equilibrium-obsessed economic managers. It is the growth of private debt relative to income.⁴ In Australia, this ratio has been growing exponentially for 44 years.

I could be accused of hyperbole with that statement, so let's bring in some statistical rigour here. An exponential fit to the data shows that the ratio of debt to GDP has been growing at 3.9% per annum since 1963. The regression returns a correlation coefficient (“ R^2 ”) of 0.99. You simply can't get a better fit than that.⁵

⁴ This is the sum of mortgages, personal and business debt.

⁵ For the uninitiated, R^2 is a measure of the degree of correlation of two series, and the maximum value it can take is 1.00. Most economists are happy to get a value of 0.4 or above for their models; anything about 0.7 is cause for celebration. A correlation of 0.99 is either simply ridiculous—or it's telling us something very profound about our economic system.

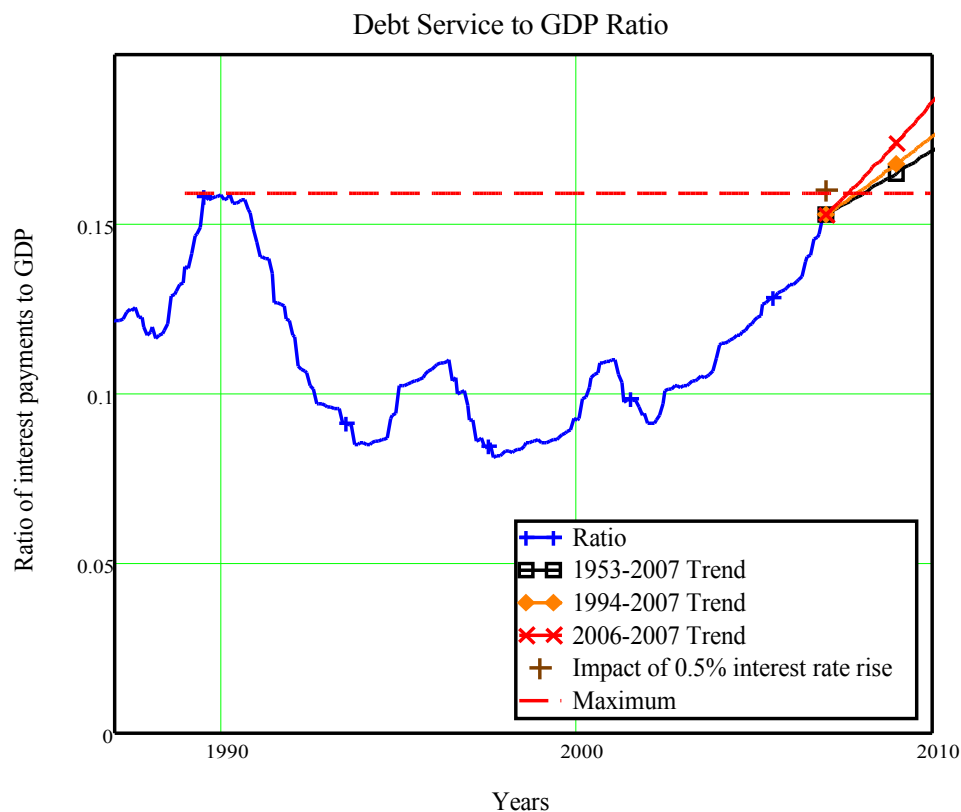


In 1960, debt was 28% of GDP; in 1970, 32%—pretty low levels. But in 1980, it was 49%; in 1990, 73%; by 2000, it was 108%, and today it is 152%, a staggering *one and a half times* the level that brought Japan to its knees in 1990.

The usual equilibrium attempts to explain this phenomenon just don't hold water. I've heard economists dismiss the rise in debt levels as just a rational response to interest rates being much lower today than in 1990. Yes, interest rates today are lower than those of 1990; but they're higher than those of the 1960s and early 1970s, when debt was a lot lower. And the rise in debt has been so great that the debt burden is now within a whisker of what it was in 1990—hardly a year that one could characterise as an instance of equilibrium.

Unfortunately, the growth in debt has more to do with irrational exuberance and disequilibrium than rationality and equilibrium. Households in particular have taken on enormous and unprecedented levels of debt levels, primarily to finance speculation in real estate. Mortgage debt rose by about 450 per cent relative to GDP between 1990 and now—rising far more than interest rates fell. We now have the quandary that Australia's continued prosperity depends upon the inflated price of housing not falling, while at the same time we have amongst the most over-valued housing in the world.

The rise in debt has been so great, that we would experience 1990 debt servicing levels if interest rates rose by a mere half a per cent. Even more worrying is the fact that, even without any further rises in interest rates, we'll exceed this historic and painful maximum if the trend rate of growth of debt to GDP continues for just one more year—and if the higher rate of growth of 2006 applies, we'll be there by mid-2007.



Yet Michael countenances that the RBA could control an inflationary outbreak by varying the rate of interest. We can't afford to—not unless we want a repeat of “the recession we had to have”. And surely Michael remembers what that was like.

In these circumstances, the “clear and present danger” that the Australian economy faces is not inflation, but a debt-induced downturn like Japan's in 1990. And if such a downturn occurs, then it would be criminally bad management for the government to continue the obsession with maintaining a surplus. Circumstances alone will force the government into deficit, as tax revenues evaporate and social security spending rises.

That non-discretionary, “homeostatic feedback” effect of the way the government raises and disperses its money is an important part of the means by which the private sector recovers from excesses like the speculative bubble of the last 13 years. The government deficit turns up as money in private bank accounts, and enables individuals and companies to pay their debt levels down. In the aftermath to a debt-induced downturn, a government deficit is a sign of responsible economic management. A continued focus upon surpluses, on the other hand, would be a sign of an intellectual obsession with equilibrium that has no place in the real world.