ECONOMIES IN CRISIS

Part 2: The Global Financial Crisis:
Impact on Australia

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Introduction

- The Australian economy in 2009
- Neoclassical vs. Post-Keynesian economic theories
- Debt in Australia

1. 2009

- Economic outlook for 2009
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Outlook for 2009

Nouriel Roubini:

- “The global financial system in 2008 experienced its worst crisis since the Great Depression… The global financial system literally went into a cardiac arrest… So what lies ahead in 2009?… Unfortunately the worst is ahead of us.”

Source: “Worst Still Is Ahead of Us”,

1 January 2009, Bloomberg

Banks

- Australian banks appear to be in reasonable shape, although things will get tougher.
- The current account deficit issue - our susceptibility to high private debt levels against a falling Australian dollar - will come home to roost.
- Yet regulatory settings and superior risk management have stood Australian banks in reasonably good stead.

Source: “Bank Risks Remain”, Michael West,

11 December 2008, The Age

Banks

- What about the government's emergency bank guarantee, in which all deposits were guaranteed for three years and deposits over $1 million per Australian Depository Institution was subject to a fee?
- It was fast and arbitrary, and caused a debilitating exodus from mortgage funds, but it restored confidence and may have saved St George (taken over by Westpac) and Suncorp banks.

Source: "Bank Risks Remain", Michael West,

11 December 2008, The Age

Banks

- The mortgage market is contracting by between 40% and 50% and banks depend on mortgages for 60% of their profits.
- Banks will defend their profits to the death, which means they may have to increase their spreads on all base products.

Source: “Bank Risks Remain”, Michael West, 11 December 2008, The Age

Banks

Worst case scenarios:

- The government’s wholesale funding guarantee fails to enable banks to raise money overseas.
- One or more banks fail, and the government has to pay out depositors.
- Australia’s national credit rating is downgraded.

Source: “Bank Risks Remain”, Michael West, 11 December 2008, The Age

Inflation

Nouriel Roubini:

- “This severe global recession will morph into stagdeflation, a deadly combination of economic stagnation/recession and deflation.”
- “Falling prices mean that the real cost of capital is high and the real value of nominal debts rise. This leads to further declines in consumption and investment, thus setting in motion a vicious circle in which incomes and jobs are squeezed, aggravating the fall in demand and prices.”

Source: “Worst Still Is Ahead of Us”,

– 1 January 2009, Bloomberg

Inflation

- Consumer price inflation is no longer an issue for the Australian economy in the short term.
- Therefore interest rates are likely to decline further early in 2009, remain low throughout the year, and quite possibly stay low well into 2010.
- If there are signs that the Australian economy is beginning to recover from the GFC by the end of 2009, which is a best-case scenario, interest rates could start to increase in 2010.

Inflation

Two unanswered questions:

- If we enter a period of stagdeflation and if governments become the lenders of only resort and monetize debt, will consumer price inflation return with a vengeance?
- And if so, when might that be?

Growth

Australia’s quarterly growth was in decline well before the collapse of Lehman Brothers, and the onset of the GFC, on 15 September 2008:

- Q3 2007: 1.1% growth;
- Q4 2007: 0.9% growth;
- Q1 2008: 0.6% growth;
- Q2 2008: 0.4% growth;
- Q3 2008: 0.1% growth.

Source: “Warning Signs in Place Before Global Meltdown”, Ross Gittins, 6 December 2008, SMH

Growth

- Growth in Australia is likely to decline in 2009.
- Q4 2008 growth figures will provide the first indications of the 2009 growth outlook.
- Given the deteriorating global economic environment, if these figures are weak despite the government’s $10 billion stimulus package, Australia will most likely go into recession during 2009. A second stimulus may avert this.

Unemployment

- In 1932, in the Great Depression in Australia, unemployment rose to 30%.
- In the current recession, some commentators believe that the unemployment rate will rise from about 4.5% to 10% or 12%.

Source: “It’s Not All Bad News”, Ross Gittins, 29 October 2008, SMH

Unemployment

- Some commentators suggest that an unemployment rate of 6% or more indicates that an economy is in recession and an unemployment rate of 10% or more indicates that an economy is in depression.
- Some sectors of the Australian economy will be worse hit by unemployment than others.

The stock market

‘Emerging consensus view’:

- “The Australian stock market will offer investors the best buying opportunity in a generation in 2009, after the bourse suffered its biggest annual decline ever in 2008… The returns on shares are now significantly higher than the alternatives.”

Source: “Bargains Await Investors in 2009”, 24 December 2008, The Age

The stock market

Nouriel Roubini:

- “An emerging consensus argues that the price of many risky assets - including equities - have fallen so far that we are at the bottom and a rapid recovery will occur… [But from here there is] a chance of a 20% fall in global equity prices.”

Source: “Worst Still Is Ahead of Us”,

1 January 2009, Bloomberg

The stock market

Steve Keen on investment in general:

- “[The term] “investment” as Australians’ use it translates as speculation. In the current climate I don’t think there is any asset who’s price will rise faster than income, so the best investment is to pay down your debt. In the current circumstances what matters most is liquidity, not capital gain.”

Source: “Chat: Professor Steve Keen”,

8 October 2008, 60 Minutes

Housing prices

Steve Keen:

- "I think something of the order of 40% of [housing] prices are simply financed by people's expectations that prices will keep on rising. Well when this expectation goes, ultimately goodbye to 40% of the current price of houses."

Source: "Brace Yourselves for Recession",

– 4 August 2008, ABC

Housing prices

Steve Keen, to a 26 year old wanting to buy a house:

- “Houses in Australia are at the highest they have been, so stick with renting for the meantime. Wait until prices have fallen substantially. When they fall within 3 times [annual] income, not 7 as they are now, it would be a good time. Now just isn’t sensible.”

  Source: “Chat: Professor Steve Keen”,
  - 8 October 2008, 60 Minutes

2. Neoclassical vs. Post-Keynesian Economic Theory

- Neoclassical economic theory
- Post-Keynesian economic theory, and the work of Hyman Minsky

Neoclassical theory

Key aspects of Neoclassical theory:

- A market economy always tends towards equilibrium.
- Money impacts ‘nominal’ variables like inflation but has no long-term impact on ‘real’ variables like employment and GDP growth.
- Financial markets are rational - levels of private debt reflect rational calculations about the future and can therefore be ignored by policy makers.

Source: “What Is Really Going On?”, Steve Keen, DebtWatch, November 2008

Neoclassical theory

Neoclassical economists focus on three numbers:

- The rate of economic growth as measured by GDP, which preferably should be above 3% a year.
- Unemployment, which preferably should be low (recently the target in Australia was around 4.5%).
- The rate of inflation, which preferably should be as low as possible, and certainly below 3%. (The RBA 2008 Annual Report targets “consumer price inflation” at 2%-3%).

Source: “What Is Really Going On?”, Steve Keen, DebtWatch, November 2008

Post-Keynesian theory

Key aspects of the “Financial Instability Hypothesis” developed by Hyman Minsky:

- A market economy is inherently cyclical.
- Money is fundamentally credit driven, and impacts both ‘nominal’ and ‘real’ variables in the short and long term.
- Financial markets destabilise the real economy because euphoric expectations lead to debt-financed speculative bubbles.

Source: “What Is Really Going On?”, Steve Keen, DebtWatch, November 2008

Post-Keynesian theory

- In essence, the “Financial Instability Hypothesis” argues that financial systems move from stability to crisis thanks largely to speculative borrowing in good times.
- Steve Keen uses the “Financial Instability Hypothesis” to analyse Australian and US levels of debt. For his PhD, he built a mathematical model of Minsky’s hypothesis.

Post-Keynesian theory

- Economists who are influenced by Hyman Minsky - broadly known as “Post-Keynesians”, since Minsky was a follower of Keynes - focus on debt, and the ratio of private debt to GDP.
- This ratio - of the outstanding amount of debt at a given point in time to the annual output of goods and services - tells how many years of income it takes to reduce debt to zero.

Source: “What Is Really Going On?”, Steve Keen, DebtWatch, November 2008

Post-Keynesian theory

- From early 2006 Steve Keen repeatedly warned that Australia and the US were experiencing asset bubbles in both stocks and housing, and that a major crisis would start with the bursting of the asset bubbles.
- Before the GFC hit, Keen went public with his analysis via DebtWatch and his blog.

3. Debt in Australia

- Some general points from the previous session
- Steve Keen on debt

Debt

- In June 2007, the Reserve Bank said that Australian household debt had reached $1 trillion for the first time.
- Denis Orrock, of InfoChoice: “Australians [in 2007] have $40 billion racked up in outstanding credit card debt alone.”

Source: “Debt’s $1 Trillion Headache”,

John Collett, 15 August 2007, The Age

Debt

Commentators generally argue that Australia is well placed to face the GFC, but that it has two weak spots:

- Australian banks are heavily dependent on US short-term commercial funding, where lenders are reluctant to lend and rates have increased sharply.
- Many Australian households are heavily indebted.

Source: “It’s Not All Bad News”, Ross Gittins, 29 October 2008, SMH

Debt

- Steve Keen argues that the level of debt in the Australian economy as measured by the debt to GDP ratio has been on an upward trend for 44 years, and is unsustainable.
- It currently stands at 165% of GDP.

Source: Steve Keen: DebtWatch No 23

June 2008

Debt

- Gabriel Stein, of Lombard Street Research, noted in October 2008 that Australian household debt has reached 177% of GDP, almost a world record.
- "It is amazing that in the midst of the biggest commodity boom ever seen they have still been unable to get a current account surplus. They have been living beyond their means for 10 years. What worries me is that productivity growth has been very low: they have been coasting after their reforms in the 1990s."

Source: "Greed a Deadly Sin for the Economy",

20 October 2008, SMH

Debt

- The “current account” is the difference between a country’s exports of goods and services and its imports of goods and services, if all financial transfers and investments are ignored.
- A country is said to have a current account surplus if it exports more than it imports, and a current account deficit if it imports more than it exports.

Debt

Ross Gittins:

- “This is the point that’s yet to sink in: recessions come not from excessive braking to control inflation, but from excessive borrowing and the bursting of asset bubbles. These days we have balance-sheet driven recessions.”

“It’s Not Inflation, but Borrowing”,

8 December 2008, SMH

Steve Keen on debt

- “We are not in a Great Depression - not yet anyway - but a key pre-condition for one has developed right under the noses of Central Banks: excessive private debt. In fact, debt levels today are twice as high as in 1929, which is why this financial crisis is causing far more carnage than 1929 did.”

  Source: “The Failure of Central Banks”, DebtWatch, 27 October 2008

Steve Keen on debt

- “At the time of the stock market crash of October 1929, the US’s debt ratio was 150%; today it is 290%. Australia’s ratio was 64%; today it is 165%. The regulators who were supposed to keep us from the jaws of The Beast have instead led us closer towards its belly.”
- These figures do not include financial derivatives, which are another form of debt.

Source: “The Failure of Central Banks”, DebtWatch, 27 October 2008

Steve Keen on debt

- Before the Great Depression began in 1929, the ratio was 64%. Today Australia's debt is about the fourth or fifth worst in the world.
- "We're slightly below America, way below England, and the Netherlands is scary."

Source: "Profile: Steve Keen",

Jenny Tabakoff, 27 August 2008, SMH

Steve Keen on debt

- “The real lesson of the 1930s is that a credit-driven market economy is fundamentally unstable, and a Great Depression occurs when debt-financed speculation results in excessive private debt at the same time as inflation is low.”
- We have the same conditions now, only much worse.

Source: “The Failure of Central Banks”, DebtWatch, 27 October 2008

Steve Keen on debt

- “Debt is necessary to finance genuine investment by businesses and houses for residences by ordinary income earners. Anything above that is unnecessary. On the history of the 1950s and 1960s, the responsible lending ceiling was about 25% to at most 50% of GDP. We are currently at 165% of GDP. Therefore about 60% to 70% of the debt has been used to finance speculation on asset prices and that is debt we should not have.”

Source: “Chat: Professor Steve Keen”,

8 October 2008, 60 Minutes

Steve Keen on debt

- Capitalism has become unhealthily focused on speculation and greed.
- The ultimate solution to the problem of debt caused by speculating on asset bubbles is to make it extremely difficult, if not impossible, for people to make a profit by speculating on assets prices in the first place.
- In order to do that we need to create a new financial system.
- “We’ve turned capitalism into a kleptocracy.” *

Source: “The World Today”, 22 September 2008, ABC

* kleptocracy - *a ruling class of moneyed elites that usurps liberty, justice, sovereignty, and other democratic rights from the people.*

References

Nouriel Roubini:

www.rgemonitor.com

Steve Keen:

www.debtdeflation.com/blogs

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