

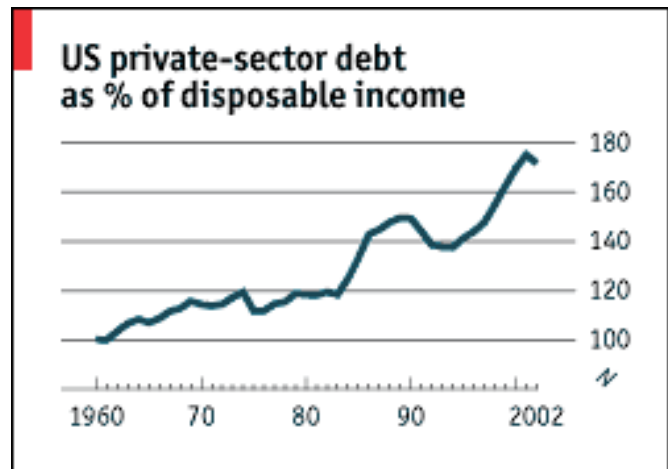
**Debt and deflation****Till debt us do part**

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**The deadly cocktail of high borrowing and falling prices**

“INFLATION rescues firms from the errors of optimism and stupidity.” John Kenneth Galbraith's words apply equally to households. Over the past three decades over-indebted companies and individuals have often been bailed out by inflation, which has eroded the real burden of their debt. In the late 1990s, though, optimism and stupidity reached new heights. In America and Europe private-sector debts rose more sharply than ever before in relation to GDP. Too much of this borrowing assumed unrealistic growth in future profits, share prices or incomes. But for the first time in decades, inflation can no longer rescue bosses and consumers from their folly.



High inflation harms growth. But it can sometimes be useful, especially for debtors. It also makes it easier for asset prices to adjust back to sensible values. If the prices of property or shares, against which people have borrowed, rise to unsustainable levels in relation to incomes or profits, their return to equilibrium is less painful if inflation pushes up incomes, rather than house prices, say, having to drop in absolute terms. In a world of near-zero inflation or even deflation there is a far bigger risk that house prices will fall.

Consider Britain's overheating housing market. House-price booms in the 1970s and 1980s turned to bust, with house prices falling by 25% or more in real terms. This was achieved in the high-inflation 1970s with no fall at all in nominal prices. But in the early 1990s average prices fell for four years, albeit by a modest 8% overall. Today, with inflation even lower, a fall in nominal house prices could be a lot bigger.

Even more worrying, some economies may yet follow Japan's into deflation, a state in which the average price level is falling. If growth in America stays below trend, increasing over-capacity will continue to reduce inflation, pushing the economy towards modest deflation. In Germany, where interest rates set by the European Central Bank are too high for its feeble economy, deeper deflation is possible (see [article](#)). Deflation and debt do not mix well.

Mortgage debt has been rising particularly rapidly. Indeed, the housing market has helped to support the world economy over the past year. Most dramatic has been the 24% surge in British house prices in the year to September. As house prices have risen, many countries, including

America and Britain, have seen record levels of mortgage-equity withdrawal, as owners borrow more against the rising value of their property. This allows consumers to spend more of their apparent wealth on cars, furniture and so on. Through new mortgages as well as refinancing, some home-owners are now borrowing up to 100% of the value of homes. So rapid has been the surge in household debt that despite low interest rates, total mortgage payments are already close to record levels as a share of disposable income in both America and Britain.

## Home economics

It is often argued that neither the level of household debt nor the lofty level of house prices need be a problem, so long as interest rates do not rise significantly. With inflation low, any rise looks unlikely in the near future. Typical home-buyers will also find that, for any given real rate of interest, it makes sense to borrow more when inflation is low than when inflation is high. This is because low inflation flattens the time profile of real debt repayments, making a mortgage more affordable in its early years. This, in turn, could, in theory, justify higher house prices relative to income.

But the ability to repay debt depends not only on the level of interest rates, but also, crucially, on the rate of growth in future incomes. The surge in mortgage debt suggests that consumers are assuming that incomes will continue to rise as fast as in the past, and that house prices too will keep going up. Yet in America and Britain, among other countries, house prices are already close to record levels in relation to average incomes. In a period of deflation, incomes would be likely to fall, and a fall in house prices would then surely follow. But the nominal value of mortgage debts would remain fixed. Home-buyers who have borrowed up to 100% of the value of their properties would then be in trouble, with properties worth less than their mortgages.

Some argue that wage-cuts could not happen, so that incomes would not fall in nominal terms. But companies are up to their neck in debts, and will be under huge pressure to cut costs in a deflationary environment. If firms cannot cut wages, then as falling prices squeeze profits, they will cut jobs. Debt deflation is an especially big risk in Germany, where corporate debts are dangerously large. How long will it be before even Germans wonder if inflation, their old foe, was really so bad? Yet that is the wrong lesson. The correct one is that, if you borrow recklessly, do not expect any bail-out.