

MACROECONOMICS AT WORK EXERCISE

THE IMPLICATIONS OF CONSUMER DEBT

REFERENCE: 'Soaring debt has economy on edge' (by Geoffrey Newman), *The Weekend Australian*, August 28-29, 2004, p. 41.

CHAPTERS RELEVANT TO THIS EXERCISE: 3, 11, 13, 16

CONTEXT

Consumer expenditure is responsible for the creation of about two-thirds of GDP. The decision by consumers to spend is influenced by many factors, among which the level of their disposable income is the most important. This will be principally determined by consumers' level of current income (e.g. from wages and salaries) *plus* the extent to which this income is augmented by increasing debt – i.e. by borrowing. In recent years the level of consumer debt has risen considerably, and been responsible for the high level of consumption expenditure and hence GDP – and the high rate of growth of GDP. Borrowed money has to be paid back, however. In addition, *interest* has to be paid. Repayments can be made from future flows of income, but the *level* of repayments (and hence that part of future income which is left over to fund current expenditure) will be influenced not only by the size of the debt that has to be paid back but also by the rate of interest that has to be paid. This rate will be influenced by the general level of interest rates that is determined by Reserve Bank policy. The effect of monetary policy (and hence the level of interest rates) on consumer demand, and hence GDP, will be magnified by a high and increasing level of consumer debt.

QUESTIONS

1. What has been the magnitude of the increase in consumer debt in recent years?
2. What are the principal means by which consumers have increased the level of their debt?

3. How do higher levels of consumer debt make future consumption expenditure more susceptible to changes in the general level of economic activity and to monetary policy?
4. Why is the state of the property market of particular importance in this regard?
5. Outline the 'disaster scenario' predicted by some economists. Do you think that this is likely?
6. What is the significance of the lower rate of inflation that has been experienced for the last ten years or so compared with the 1980s?