

# Debt, Financial Stability, And Public Policy

*By Bryon Higgins and Thomas J. Merfeld*

Most major types of debt have grown rapidly in recent years. The most publicized aspect of the overall growth in debt has been the unprecedented size of federal government budget deficits. But debt of households and businesses has also grown rapidly, and the debt of developing countries has risen so much that exceptional efforts by international lending agencies, creditors in developed countries, and the developing countries themselves have been required to prevent widespread defaults.

The buildup in debt could imperil the stability of the financial system, according to some analysts. They argue that the heavy debt burdens have reduced the ability of financial institutions, borrowers, and the economy at large to withstand recessions and other types of adversity. The resulting increase in financial fragility could force the Federal Reserve to choose between financial stability and price stability as the primary goal of monetary policy.

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Several changes in public policy have been recommended to alleviate the effects of the high level of debt. Reform of tax laws, regulatory policies, and financial disclosure requirements—as well as changes in the government's fiscal policy—have been advocated as ways of reversing what has been called “the leveraging of America.”

To gain a better understanding of the possible threats to financial stability from the buildup in debt, the Federal Reserve Bank of Kansas City sponsored a symposium on “Debt, Financial Stability, and Public Policy” on August 27-29, 1986. Symposium participants agreed that U.S. government budget deficits and the heavy debt burden of less developed countries (LDC's) threaten financial stability, but they disagreed on whether the debt of businesses and households was also worrisome. Except for a consensus that government budget deficits should be reduced, there was no clear agreement on what public policy actions are needed to protect the stability of the financial system.

This article highlights the issues raised by speakers at the symposium. The first section pro-

vides an overview of the growth in domestic debt and of the issues raised by that growth. The second section focuses on the consequences of the LDC debt problem and on policies for dealing with that problem. The third section presents possible regulatory and macroeconomic policy responses to the overall increase in debt. The final section provides the comments of three current or former policymakers on issues raised at the symposium.

### **Domestic debt and financial stability**

Presentations by Henry Kaufman and Benjamin Friedman documented the acceleration in growth of domestic debt and assessed its consequences. Both Kaufman and Friedman felt that rapid debt growth has imperiled financial stability. They also expressed concern that the Federal Reserve might thus become less aggressive in pursuing anti-inflationary policies.

#### *Debt and financial stability: an overview*

In "Debt: The Threat to Economic and Financial Stability," Henry Kaufman developed his thesis that the high level of debt will result in major economic and financial disruptions unless structural changes are made.

The rapid growth in domestic debt has been accompanied by a deterioration in the quality of credit, according to Kaufman. Growth in total debt has increased both absolutely and relative to GNP. After increasing at an average rate of 7.3 percent in the 1960s, total debt grew at a rate of 11.1 percent in the 1970s and has grown at a rate of 11.8 percent so far in the 1980s. As a result, the ratio of debt to GNP has risen from about 1.5 in the 1960s and early 1970s to about 2.0 by the mid-1980s. While this rapid growth was occurring, the agencies that rate creditworthiness of debtors have lowered credit ratings for the business sector. For example, over the last decade, the number of Aaa-rated industrial and

utility corporations has been cut by more than half, and the number of bank holding companies with the highest credit rating has declined from 14 to only one. Kaufman attributed the overall deterioration of credit quality to an "audacious leveraging strategy" that has resulted in many corporations substituting debt for equity.

Recent trends in the financial markets have contributed to the increase in debt. Financial markets have become more integrated both domestically and internationally, and depository institutions are not as "compartmentalized" as they were before deregulation. Moreover, such financial innovations as floating-rate financing, securitization of debt, and financial futures have reduced the cost of credit by reducing the risk incurred by borrowers. And the tax structure has encouraged the use of debt rather than equity because dividend payments and capital gains are subject to full taxation, while interest payments are tax deductible. Finally, deposit insurance and market perceptions that the federal government will not allow a large financial institution to fail have further reduced the perceived risk of borrowing. These developments, according to Kaufman, raise the vexing question, "Who is the real guardian of credit?"

Increased debt could also intensify the effect of a recession. Higher debt requires greater cash flows to make interest payments, but a recession would curtail cash flows. In the best case, debt servicing would preempt existing income, leaving less for investment and profits. In the worst case, the existing income would be insufficient to meet debt servicing obligations. In either case, Kaufman said, the high level of debt financing would make any recession worse.

Kaufman concluded that the Federal Reserve will be forced to follow an accommodative monetary policy to avoid the severe recession that the high level of debt could cause. It must be recognized that such a policy could reignite inflation. Yet moving away from the large budget deficits that have contributed to the financial

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**Debt and Financial Stability**

Bruce K. MacLaury, President, The Brookings Institution, **moderator**

**Debt: The Threat to Economic and Financial Stability**, Henry Kaufman, Managing Director, Salomon Brothers Inc

**Increasing Indebtedness and Financial Stability in the United States**, Benjamin M. Friedman, Professor, Harvard University

**Commentary**, Allan H. Meltzer, Professor, Carnegie Mellon University

**International Debt and Economic Instability**, Rudiger Dornbusch, Professor, Massachusetts Institute of Technology

**Commentary**, Rimmer de Vries, Senior Vice President, Morgan Guaranty Trust Company

**International Debt and Public Policy**, A. W. Clausen, Former President, The World Bank

**Financial Stability and Public Policy**

Preston Martin, Former Vice Chairman, Federal Reserve Board, **moderator**

**Regulatory Policies and Financial Stability**, Robert A. Eisenbeis, Professor, University of North Carolina

**Commentary**, George J. Benston, Professor, University of Rochester

**Commentary**, William Peter Cooke, Associate Director, Bank of England

**Debt Problems and Macroeconomic Policies**, Lawrence H. Summers, Professor, Harvard University

**Commentary**, Alan S. Blinder, Professor, Princeton University

**Commentary**, Phillip Cagan, Professor, Columbia University

**Overview Panel**

Stephen H. Axilrod, Vice Chairman, The Nikko Securities Company International

John G. Heimann, Vice Chairman, Merrill Lynch Capital Markets

L. William Seidman, Chairman, Federal Deposit Insurance Corporation

strains could lead to a recession requiring such monetary accommodation.

The inflationary consequences of the necessarily accommodative monetary policy can be avoided, Kaufman said, by making structural changes to strengthen the financial system. He advocated that the regulation of financial institutions be centralized in a National Board of Overseers to standardize and improve regulatory oversight. Moreover, financial disclosure should be increased and aimed toward revealing the overall financial health of the institution. If these steps are not effective, financial regulatory agencies should make public the creditworthiness of the institutions they regulate. Tax policies should also be changed to discourage excessive borrowing. A major improvement in this regard would be eliminating double taxation of dividends and the capital gains tax on equities. Finally, international cooperation among regulatory agencies should be strengthened. Punctuating the importance he attaches to the problem, Kaufman urged that such policy changes be adopted before "the debt problem has completely overwhelmed us."

### *Dimensions of growth in domestic debt*

In "Increasing Indebtedness and Financial Stability in the United States," Benjamin Friedman developed in more detail many of the themes touched on by Kaufman. Friedman concluded that higher debt has increased the vulnerability of the U.S. economy to financial instability and has thus made the Federal Reserve more likely to err on the side of expansionary policy, risking higher inflation.

Friedman documented in detail the increased indebtedness in the U.S. economy. The ratio of debt to GNP has remained basically constant throughout much of U.S. history, but has risen rapidly in the 1980s. All major sectors of the economy have increased their indebtedness relative to income. As a result, the share of income

going to service debt has risen for households, businesses, and the government.

The primary danger for financial stability is that a recession will interrupt the cash flows of households and businesses, making it difficult to meet debt servicing obligations. Default by some borrowers would reduce cash flows to their creditors, which would then be unable to meet debt payments and would be forced to reduce demand for goods and for workers. In this way, inability to service the high level of debt could lead to a cumulative crisis in the financial system and to a progressive decline in output and employment.

The concentration of debt in low to middle income households increases the likelihood of personal defaults in times of financial stress. Friedman's research reveals that the household sector as a whole maintained a fairly constant ratio of assets to debt in the recent debt surge. Therefore, in the aggregate, households have not increased their exposure to debt. However, consumer credit, often held by lower income households, has accounted for much of the household debt increase. Because low to middle income families have taken on such heavy debt obligations, a recession that disrupts the cash flow that these households depend on to service their debt could lead to a surge in defaults on household debt.

By substituting debt for equity financing, the corporate business sector has made itself heavily dependent on current cash flows. According to Friedman, the recent wave of leveraged buyouts is responsible for much of this substitution because corporations borrow funds to buy shares in their own firm or in other firms. While this increase in business's debt-asset ratio does not directly threaten financial stability, any disruption of cash flows could prevent firms from meeting their debt obligations.

Higher inflation could thus be the ultimate consequence of increased indebtedness. The increased likelihood of debtor distress during a recession could reduce the Federal Reserve's tolerance for

allowing a business downturn, Friedman said. As a result, U.S. monetary policy is likely to be more expansionary during a period of high debt, leading to higher inflation on average.

In discussing Friedman's paper, Allan Meltzer argued that Friedman had overstated the danger of higher debt. According to Meltzer, the growth of business debt has been moderate. Whereas Friedman studied debt to income ratios, Meltzer proposed focusing on business debt relative to assets and net worth. By these criteria, debt is lower now than in the past. Those expressing concern over rising debt have ignored the parallel increase in asset values.

Meltzer also argued that the level of debt is not a good indicator for monetary policy. Debt gives ambiguous signals about the economy. For example, a high ratio of debt to income may indicate either high current consumption or increased business investment. According to Meltzer, the Federal Reserve will realize that debt is not a good policy tool and thus refrain from an overly stimulative policy response to it.

### **International debt and financial stability**

The sharpest disagreement at the symposium regarded the best approach to the debt problems of less developed countries (LDC's). Rudiger Dornbusch advocated a fundamental change in U.S. policies toward heavily indebted LDC's and their creditors. In contrast, Rimmer de Vries and A. W. Clausen urged that the current framework for resolving the LDC debt problem be retained, with only minor adjustments as needed to adapt to changing conditions.

#### ***The case for fundamental change***

In his paper, "International Debt and Economic Instability," Rudiger Dornbusch argued that the current approach to the problem of heavily indebted developing countries is a failure. He advocated more U.S. government involvement and

reduced debt servicing burdens for LDC debtors as the most realistic alternative to the current policies, which he considers to be failures.

Dornbusch traced the origin of the LDC debt problem to both domestic mismanagement and deterioration in the world economy. Many LDC's held their exchange rates at unrealistically high levels in the 1970s while they removed constraints on international trade and capital flows. A resulting speculative flight into foreign assets caused capital flight of \$70 billion or more from LDC's in the early 1980s. At the same time, world economic growth slowed and real interest rates soared, reducing export earnings and increasing the interest cost of foreign debt. As a result, Latin American and other LDC debtors could not service their external debt.

The LDC debt problem has not improved since 1982, when it became apparent that Mexico could no longer meet its foreign debt payments. Whereas the problem was initially viewed as merely one of liquidity that would be solved as the terms of trade and the world economy improved, it has become apparent, according to Dornbusch, that the problem is one of insolvency rather than illiquidity. Moreover, the world economy has not picked up enough to raise commodity prices. Yet higher commodity prices will be necessary for most Latin American debtors to improve their export earnings enough to service their external debt. As a result, most LDC debtors have continued to borrow, increasing their debt with no realistic expectation of being able to pay the interest, let alone the principal. Despite government spending cuts and other austerity measures by LDC debtors, the international debt problem has continued to worsen because large American banks, the U.S. government, and international lending agencies have followed a policy of "involuntary debt service." Dornbusch said this policy has led to "extraordinary costs to debtors and to the trading interest of the creditor countries."

Dornbusch concluded that a new approach is necessary to solve the LDC debt problem and reviewed several of the recent proposals. He characterized as naive proposals that contemplate a reversal of capital flight because the conditions that led to the capital flight from LDC's are still present. Moreover, swaps of debt for equity, in which a bank or an investor who has acquired LDC debt in the secondary market exchanges the debt for an equity position in a company sold by the LDC government, cannot be counted on for more than a small part of an overall solution. Such a solution requires, in Dornbusch's view, that the LDC debt problem be viewed not just as a banking problem but also as a problem for U.S. industry, since the improvement in the trade balances of LDC debtors necessary to service their external debt has been associated with a major reduction in U.S. exports to those countries. The "Bradley Plan," for example, would be a major improvement over the current approach toward LDC debt, Dornbusch said. Senator Bradley has proposed targeting limited debt relief for LDC debtors in exchange for trade and other concessions in the overall interest of the United States. Under this plan, qualifying LDC debtors would be eligible for a three percentage point reduction in the interest rate on the debt and a 3 percent writedown of the principal. In addition, a pool of an extra \$3 billion in funds from international lending agencies would be made available to LDC debtors. In Dornbusch's view, the Bradley Plan recognizes the LDC debt problem as a broad political issue in which the Congress should become involved to further the interest of the U.S. economy as a whole rather than "the narrow and shortsighted interest of banking only."

### *The case for modest adaptation*

Rimmer de Vries gave a spirited rebuttal to Dornbusch's analysis. He emphasized that progress has been made through the current case-by-

case approach to LDC debt, offering Brazil as one outstanding example. The Brazilian economy is growing rapidly without inflation, and its interest payments as a percentage of export earnings have dropped to half of the 1983 level. Moreover, U.S. banks have reduced their exposure to LDC's and have thus improved the stability of the U.S. financial system. And the debtor nations continue to work constructively with commercial banks in developing solutions to their mutual problems.

The remaining problems should be resolved on a case-by-case approach with an assortment of tools, de Vries said. Some policy recommendations may apply to some countries but not to others. For example, countries with weak internal economies should make structural reforms, while the most pressing need for others is to increase the private sector's ownership and control of businesses. The International Monetary Fund should be accommodative where the conditions warrant. In addition, debt for equity swaps could benefit all parties involved. Finally, de Vries argued that capital flight could be reversed, thereby reducing external debt without serious damage to the LDC economies or to the international financial system.

de Vries argued that neither banks nor creditor nations should pursue policies for the outright debt relief proposed by Dornbusch. Instead, facilitating LDC access to international capital markets should be the primary goal of all parties. Merely forgiving principal would dissuade new lending to LDC's for years. Proposals such as the Bradley Plan would politicize the issues and set the interests of U.S. banks against those of U.S. manufacturing and trade. Nor would these plans achieve the goal of increasing debtor countries' access to capital markets.

In his luncheon speech, A. W. Clausen urged a multifaceted approach to the solution of the LDC debt problem. He argued that sustained economic growth in the developing countries was necessary not only to restore their creditworthiness in

international markets but also to alleviate the poverty that threatens political and social stability.

Developed countries have a key role in providing an environment for sustained growth in developing countries, according to Clausen. Sustained growth in developing countries is essential if LDC debtors are to expand their exports enough to service debt while making progress in alleviating domestic poverty. High government budget deficits in industrial countries impede sustained growth in the world economy and keep real interest rates high, forcing debtor nations to devote more of their incomes to interest payments on their debts. To Clausen, the implication is clear: economies with persistently high budget deficits must reduce them, preferably through cuts in public spending—especially spending for commodity subsidies that undercut efforts by LDC's to increase their commodity exports to industrial countries.

But controlling budget deficits will be inadequate unless developed countries make additional capital available to LDC debtors and maintain an open trading system that allows LDC's to expand their exports. According to Clausen, protectionism is one of the primary threats to the prosperity of developing countries and thus to their ability to service debt. Developing countries must also maintain adequate capital flows to the indebted countries, including support for the international lending institutions that play the central role in restoring growth and equilibrium to heavily indebted LDC's. Japan, in particular, could find it beneficial to increase its capital flows to developing countries.

None of the efforts of developed countries will succeed, however, without policy reforms in the LDC's themselves. A key to providing adequate economic growth in many developing countries is the revitalization of their agricultural sectors. Agriculture is typically the largest sector in the economy and, therefore, the one that promises the best hope for broad-based economic growth and rising incomes.

## **Public policies for financial stability**

Participants on the second day of the symposium addressed issues regarding policy measures to enhance financial stability. The role of regulatory policy in preventing debt growth from leading to a financial crisis was addressed first, and the possible role of monetary and fiscal policy in enhancing financial stability was then evaluated.

### *Regulatory policies and financial stability*

Robert A. Eisenbeis, in his paper "Regulatory Policies and Financial Stability," argued that many of the problems attributed to deregulation of the financial system are actually legacies of flaws in financial regulation and the deposit insurance system. He offered several suggestions for revising those policies to ensure that the financial system is less vulnerable to crisis.

According to Eisenbeis, ill-conceived regulations are the root causes of many of the problems in the financial system. Although financial innovations are often blamed for increasing financial fragility, these innovations are typically designed to circumvent financial regulations. While the regulations are well intentioned, they disrupt market efficiency and give rise to practices that weaken the financial system. Deposit interest rate ceilings and reserve requirements, for example, led depository institutions to rely increasingly on short-term funds, widening the maturity gap between assets and liabilities and increasing interest rate risk. Similarly, regulatory limitations on geographic and product expansion have prevented the asset diversification needed for limiting risk of depository institutions. As a result of these and other regulatory constraints, an increasing amount of credit is "securitized" or otherwise diverted to less regulated markets, including off balance sheet activities of commercial banks and the corresponding practices of brokerage firms. In short, Eisenbeis viewed many

of the financial innovations that threaten the safety of the financial system as practices that “have been pursued and have prospered, not because they necessarily improved efficiency . . . but rather because of their productivity in regulatory avoidance.”

The current deposit insurance system is particularly damaging because it encourages excessive risk taking. Because the cost of deposit insurance to an institution is based on the size of its deposit base rather than on the riskiness of its assets, the deposit insurance system allows institutions to acquire risky assets without incurring a commensurate increase in costs. The resulting subsidy to risk taking is a particularly acute problem in the case of weak institutions that can hope to survive only by investing in high yield, high risk assets.

On the basis of his analysis, Eisenbeis proposed several policy changes to enhance the safety and soundness of the financial system. First, deposit insurance should be priced so that institutions bear the cost of risk taking. Second, regulatory agencies should close financial institutions when their net worth reaches zero. Any plan to prop up failing institutions not only subsidizes their subsequent losses but also establishes a precedent that encourages other institutions to invest in risky assets. Third, the Federal Reserve should provide discount window loans only at rates above market rates to discourage institutions in financial difficulty from taking risks. More generally, Eisenbeis argued that financial deregulation should continue because only in this way can market forces exert the necessary discipline to discourage the type of risk taking that has endangered the stability of the financial system.

Discussant George J. Benston basically agreed with Eisenbeis, but added that the Federal Reserve should concentrate on preventing systemic financial crises by proper regulation of the money supply and interest rates. According to Benston, the Federal Reserve should not be concerned with the failure of a single financial institution, because

a single failure would not induce systemic financial distress. On the other hand, an inappropriate monetary policy can cause a general economic depression or aggregate price inflation. Therefore, the Federal Reserve should concentrate on avoiding systemic instability through proper use of monetary policy.

In discussing the paper by Eisenbeis, William Peter Cooke agreed that deregulation did not cause the current stress in the U.S. financial system, but he disagreed with many of Eisenbeis’s policy recommendations. First, the risk-based deposit insurance system proposed by Eisenbeis is unnecessary, Cooke believed. If regulatory authorities want to impose costs on deposits commensurate with the risks that institutions assume, they should discontinue the deposit insurance system altogether. The market would then conduct its own risk assessment and charge more for deposits backed by risky assets. Second, banks should not be closed when their net worth becomes zero, according to Cooke, because of the difficulty in valuing a bank. A zero net worth might be only temporary, and the valuation under an assumption of closure would be different from the valuation under an assumption of ongoing business. Third, the Federal Reserve should not charge penalty rates for discount window borrowing. The market itself could theoretically lend money at a penalty rate. But the function of the lender of last resort is to provide access to funds for a troubled but solvent bank. Lending at penalty rates would defeat the purpose of having the central bank as a lender of last resort and could thus force premature insolvency.

### *Macroeconomic policies and financial stability*

In “Debt Problems and Macroeconomic Policies,” Lawrence H. Summers concluded that macroeconomic policies can best contribute to financial stability by keeping the real economy

on an even keel. Reducing government budget deficits is particularly important for alleviating financial stress.

High growth in private sector debt is less of a threat to financial stability than is often thought, according to Summers. Financial stress depends on changes in net worth rather than on growth in debt. The ratio of farm sector debt to GNP has declined in recent years, for example, despite the evident agricultural financial distress, which has been caused by a shrinkage in the value of assets rather than growth in debt liabilities. While adverse shocks have led to financial distress in the agricultural, energy, and some manufacturing sectors, Summers argued that there is "little basis for generalized concerns about the excessive growth of private sector debt."

Nor is the ratio of total debt to GNP a good indicator for guiding monetary policy, Summers argued. Policy guides should give unambiguous signals of future movements in GNP. But broad debt measures do not give such signals. So, while broad debt aggregates can provide some useful information for monetary policy, they should not be the sole target variables.

In contrast, fiscal policy should be concerned with excessive debt growth because much of it has resulted from the unprecedented size of government budget deficits. Theoretical arguments that budget deficits could be offset by additional private saving are not borne out by experience, according to Summers. As a result, budget deficits increase the financial stress of private sector debtors by raising real interest rates. Moreover, budget deficits have particularly adverse effects on some sectors of the economy by creating disruptive shifts in the composition of output. For example, the strong dollar associated with high budget deficits has made U.S. agricultural exports less competitive on world markets. The most direct way of enhancing profitability and reducing financial stress of the agricultural and other depressed sectors would be to lower federal budget deficits.

Overall, quick reduction in budget deficits would "enhance both financial stability and economic growth."

Summers proposed reforming the current tax law as another way fiscal policy could reduce debt growth. The tax system subsidizes use of debt finance by corporations by allowing tax deductions for business interest costs but not for dividend payments. Summers argued that without such tax distortions, "corporations would find it profitable to issue less debt and take on fewer risks."

To remedy this type of distortion, Summers advocated a consumption tax and elimination of all interest deductions. Both changes would reduce the tax incentives favoring debt finance.

Alan Blinder agreed with Summers's conclusions that rising interest obligations increase financial stress and that budget deficits exacerbate the problem. But he added some additional qualifications. He pointed out that, contrary to claims by Summers, higher private debt need not be offset entirely by higher assets. In recent years, for example, an increasing fraction of private borrowing has been from foreign lenders. Moreover, the high real interest rates of recent years pose a greater risk of default and economic instability than Summers implies, especially during a period of disinflation. The effect of high real interest rates are no longer predominantly the crowding out of such interest-sensitive sectors as business investment. Budget deficits have increasingly crowded out export and import-competing sectors by forcing up the exchange value of the dollar. Finally, Blinder felt that most of the tax distortions favoring debt could be remedied by indexing the current tax system, a change that would weaken the case for a consumption tax.

Phillip Cagan also agreed with the major conclusions Summers reached. He added that more emphasis should be given to growth of short-term debt, which he believes poses the greatest problems for monetary policy. A financial system characterized predominantly by long-term debt

and money would reduce shifts between money and debt, thereby limiting the unpredictable changes in money demand that frustrate monetary targeting. When the effect of financial deregulation and innovation has abated, monetary targets will again become useful for implementing monetary targets, but debt targets will not, according to Cagan.

## Overview and conclusions

Three participants provided an overview of the issues raised at the symposium. The overview panelists were current or former members of government agencies charged with maintaining financial stability. For that reason, their comments focused on the policy aspects of the relationship of debt to financial and economic stability. Stephen H. Axilrod concentrated on macroeconomic policies, while John G. Heimann and L. William Seidman focused on regulatory policies.

A major point of Axilrod's comments was that there are many subtle linkages among macroeconomic policy, debt, and financial stability. He rejected debt as a monetary policy target, but argued that macroeconomic policy has contributed to the buildup of debt and that the buildup has constrained macroeconomic policy. Some of the rapid growth in debt has resulted, he said, from inflationary monetary policy in the 1970s. More recently, high budget deficits have exacerbated the inflation mentality because "people may tend to think the government will reduce its debt burden...through inflation, which, to my mind, is a form of default." Thus, in Axilrod's view, financial instability has resulted partly from past inflationary monetary policy and the high budget deficits, which have raised real interest rates.

Heimann's comments focused on ways to enforce discipline in a changing financial system. He argued that banks have a special role in our financial system but that private market forces may be inadequate to enforce prudential standards for

banks. Bank regulators are thus necessary and, in Heimann's view, have been doing the best job possible in a changing financial environment. One aspect of this "revolution in the financial services industry" is the securitization of credit, in which funds are ultimately raised in credit markets through sale of securities rather than through loans from financial intermediaries. Another aspect is interest rate swaps, which Heimann characterizes as a form of "credit bootstrapping." It is too soon to foresee the ultimate effects of these financial practices on financial stability, he said, because the practices have arisen only recently, during a period of relatively good economic and financial conditions. How the novel financial markets will function during periods of severe stress is, to Heimann, one of the major uncertainties about the final effect of rapid debt growth on stability in the financial system.

As chairman of the FDIC, Seidman focused on the vulnerability of the banking system during this period of higher debt. Although banks have increased capital as a buffer stock against shocks and developed new ways of diversifying risks, he said, they "have been failing at rates not seen since the advent of federal deposit insurance." Far more banks have failed so far in the 1980s than in the preceding four decades combined. Seidman predicted that about 150 banks could fail in 1986 and that even more could fail in 1987. He pointed out that bank failures have been concentrated in certain economic and geographic sectors. Almost 90 percent of the bank failures in the past two years were in states west of the Mississippi River, an area heavily dependent on agriculture and energy. Increased competition, interest rate deregulation, and disinflation have also taken a toll on many banks. In Seidman's view, the vulnerability of the banking sector to these developments has been accentuated by increased private sector debt.

Seidman offered several policy prescriptions to help ease strains on the banking system. Relaxation of restrictions on geographic and product ex-

pansion would help, he said. But moving toward risk-based deposit insurance to enforce market discipline is fraught with complications, including sensitivity to problems of innocent victims. Furthermore, enforcing discipline by forcing losses on depositors of failed banks could lead to loss

of confidence in the entire banking system. In evaluating the effect of rapid debt growth on the FDIC's ability to protect depositors, Seidman warned that "the current trend line in bank failures cannot be extended for many more years without trouble; the climb it evidences is too steep."

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## DEBT, FINANCIAL STABILITY, AND PUBLIC POLICY



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Most types of debt in the United States have grown rapidly in recent years. To improve public understanding of the effects of the rapid growth of debt, the Federal Reserve Bank of Kansas City hosted a symposium on "Debt, Financial Stability, and Public Policy," on August 27-29, 1986, at Jackson Hole, Wyoming. The symposium proceedings, now available, discuss the implications of rapid debt growth on the nation's financial stability and consider appropriate public policy responses.

### Past Symposiums

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