

The Rapid Growth of Debt In the United States

By Paul A. Volcker

I appreciate this opportunity to discuss the rapid growth of debt in the United States and its possible implications for our financial markets and economy. As you know, this is a subject about which I have expressed some concern from time to time over the past few years, and I welcome an exploration of the many difficult and complex issues it raises. Given those difficulties and complexities, no single hearing can do more than identify tendencies, raise questions, and point to areas for further study. In that sense, this testimony is more descriptive than prescriptive, but I think it does suggest the importance of the subject.

The increase in indebtedness since the early 1980s certainly has been extraordinary. The debt of domestic nonfinancial sectors—the measure of credit monitored by the Federal Open Market Committee—has increased at

rates ranging from around 11 to 14 percent in each of the three years of the current economic expansion. This growth has been much faster than the nominal increase in GNP and income, breaking a pattern that had persisted through most of the postwar period.

Until the early 1980s, debt and income expanded at roughly comparable rates over time, and the ratio of debt to income fluctuated at or just below 140 percent. Since then, however, as debt expansion far outpaced the growth of income, this ratio has risen sharply to almost 170 percent at the end of 1985. Historically, changes of that magnitude, up or down, are unusual except in highly disturbed economic circumstances—depressions, wars, or major inflations—not just in the United States but also, so far as comparable statistics are readily available, in other major countries. That itself raises questions as to what is different now.

In that connection, I should emphasize that there is nothing particularly significant or alarming, in itself, about one or another ratio of debt to income. Even if the statistics were

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fully comparable and accurate through time, there are a number of reasons why the ratios might change over time or between countries. One major influence, for instance, is the amount of financial intermediation characteristic of an economy. The data I just cited net out debt of defined financial intermediaries—banks, thrifts, finance companies, and other “financial” firms. But “nonfinancial” firms and governments both lend and borrow, more today than before, and, from one point of view, the related debt is double counted in the data. Stated another way, offsetting borrowings and loans on balance sheets of firms may not suggest the same risks and “leveraging” as borrowings not matched by comparable financial assets.

However, even after allowing for identified areas of double counting or greater intermediation—for instance, the spate of advance refundings late last year by state and local governments—the overall data do strongly suggest greater leveraging among borrowers; that is, a larger burden of interest and princi-

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pal payments relative to net worth and income streams. In the corporate sector, the same conclusion is implicit in the massive net retirement of equity recently, amounting to some \$150 billion over the last two years, even though retained earnings have been rising.

The willingness to take on large volumes of additional debt certainly has not impeded the economic expansion. To some degree, the high levels of borrowing have helped support the spending needed to keep the economy growing. However, at some point a rising debt load is not sustainable. Debt cannot rise with-

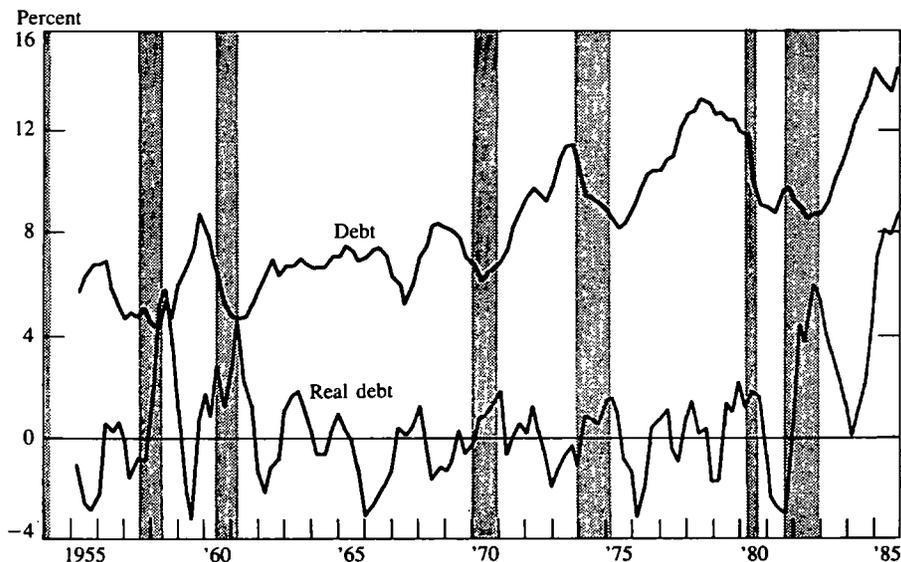
out limit relative to income needed to service it, and increased leveraging implies smaller safety margins to deal with economic adversity. Consequently, continuing rapid growth of debt has disturbing implications for the fragility of the financial system over time, and the question is especially apropos at a time when certain important groups of borrowers are already under severe financial stress. The vulnerability of the economy to unanticipated increases in interest rates or a shortfall in income appears to be increasing, rather than the reverse. Surely we must be concerned about achieving a better balance in the sources of our economic expansion if we wish it to be sustained.

Sources of credit growth

The very structure of the growth of debt in the last few years reflects underlying imbalances in our national economy. To a considerable extent, the unusually rapid growth of debt in recent years directly reflects the borrowing by the federal government to finance an unprecedented string of budget deficits. Usually, budget deficits and federal borrowing decline as the economy recovers from recession, boosting tax receipts. In the last three years, by contrast, the budget deficit has remained extraordinarily high during the expansion, and federal debt held by the public has grown by more than 15 percent each year.

The federal government is our strongest borrower, and an increase in the federal debt ordinarily would not connote greater weakness in our credit structure. Even then, however, the need to service that debt requires higher taxation than would otherwise be necessary—with consequences for economic efficiency—and pressures of government debt service have historically sometimes led to excess money creation and inflation.

Growth of domestic nonfinancial debt, nominal and real (Four quarter growth rates)



Note: Shaded areas indicate periods of recession.

Viewed from an economywide perspective, large borrowings by the federal government have typically been accompanied by small increases in private debt. In the current setting, however, borrowing by nonfederal sectors also has been unusually strong, with household, business, and state and local government indebtedness all rising relative to GNP.

In that sense, it is hard to see direct evidence of “crowding out” of private borrowing. In substantial part, the simultaneous rapid expansion of both federal and private debt has been a reflection of the relative ease with which this country has attracted savings and capital from other countries in recent years.

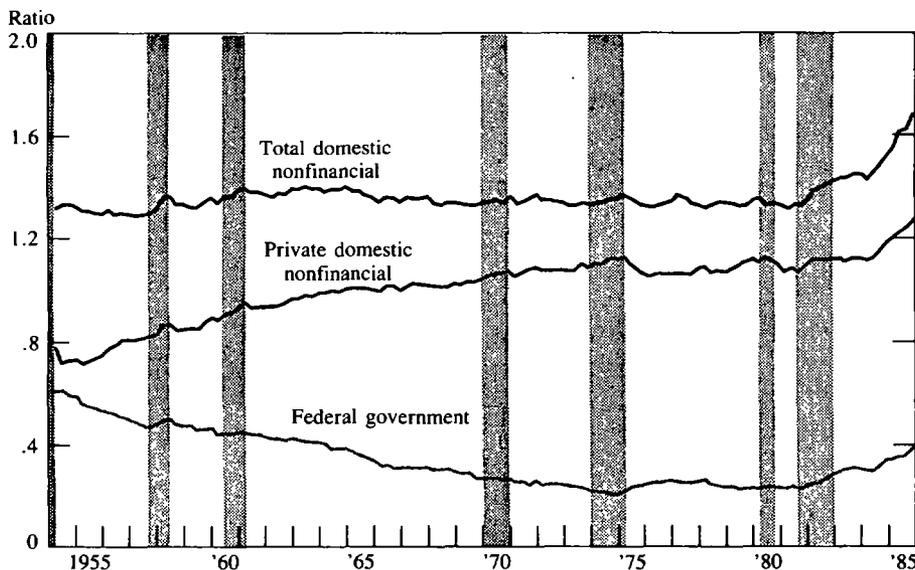
In effect, there has been a massive imbalance between the generation of loanable funds at home and the amount of borrowings. The resulting pressures on interest rates have been moderated by the capital inflow from

abroad. But that inflow exacts a price. The net transfer of financial resources has been accompanied by a similar transfer of real resources to the United States—or to put it in more comprehensible language, record trade deficits. And we have, in the space of a few years, reversed our position as the largest world creditor (net) and are in the process of becoming the largest world debtor.

We do not want those developments to continue indefinitely—ultimately they are both politically and economically unsustainable. The willingness of foreigners to advance credit to the United States is not inexhaustible, and the capital inflow and related trade deficit have been maintained at the expense of our own manufacturing industry.

Moreover, for a country as well as an individual or business, rising debt levels imply greater obligations to make interest payments out of future income. This would be less of a

Domestic nonfinancial debt (Relative to nominal GNP)



Note: Shaded areas indicate periods of recession.

concern if the foreign savings could be seen as being used to build up our domestic productive capacity, improving our prospects for growth and giving us a stronger base from which to make interest or dividend payments abroad. But with domestic investment spending relatively modest in recent quarters, it seems evident that in large measure the foreign lending is going, directly or indirectly, to fill the deficiency in domestic saving created by federal deficits. In a real sense, the rapid growth of federal debt and imbalance in foreign transactions have placed a mortgage on our future.

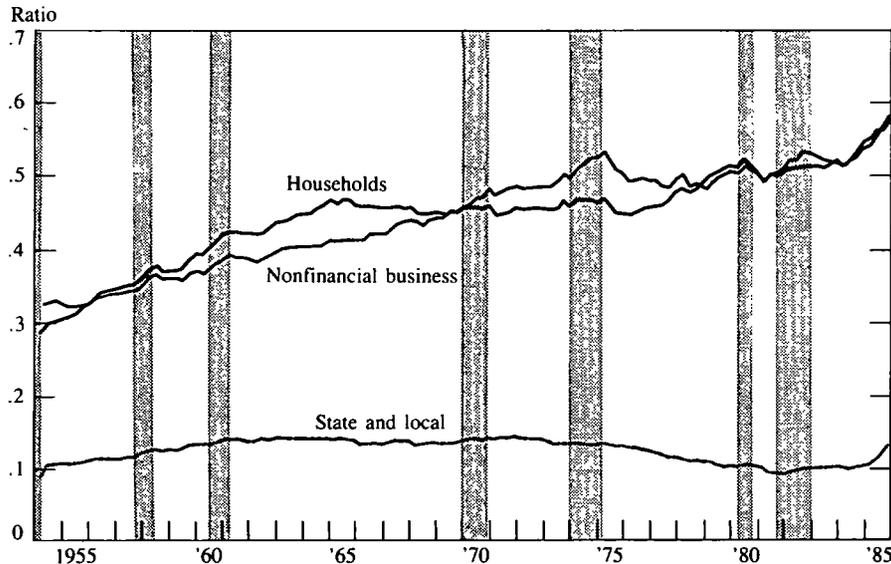
Perhaps the most striking evidence of greater willingness to incur debt can be found in the substitution of debt for equity associated with the wave of mergers, leveraged buyouts, and stock repurchase programs over the last few years. These activities resulted in the gross retirement of around \$100 billion in out-

standing equity of nonfinancial corporations in 1984 and again in 1985, funded in the initial stages primarily by new debt issues, amounts not nearly offset by new sales of equity.

The unusual volume of equity retirements may have accounted for roughly one percentage point of debt growth each of the last two years. While some of this debt may subsequently be paid down through sales of assets, or with equity obtained by sales of stock or internally generated cash flow, it seems clear that at least for some time a significant number of businesses will be carrying more debt, and therefore greater financial exposure, than if these corporate restructurings had not occurred.

These concerns are mitigated by the substantial profits and cash flow of many businesses, so that equity and cash cushions have been better maintained than debt data alone might suggest. Moreover, the recent surge in

Private domestic nonfinancial debt by sector
(Relative to nominal GNP)



Note: Shaded areas indicate periods of recession.

stock prices has greatly bolstered the market value of corporate equity—ratios of market valuations of corporate debt to equity have actually declined in the past year. Declining interest rates also moderate the debt burden. Nonetheless, the trend in debt creation, if extended, would imply some increase in financial risk for the economic system.

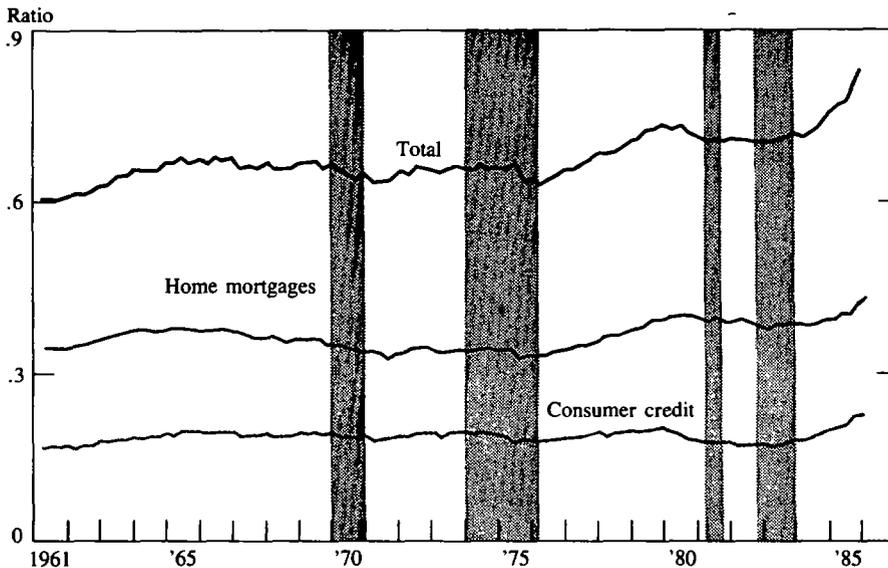
In the household sector, savings rates have been unusually low and both consumer and mortgage indebtedness has risen much more rapidly than disposable income. Some part of the rise in the ratio of debt to income for households—which stands at a postwar high—undoubtedly reflects lengthening debt maturities, shifting demographics, and greater convenience use of credit, rather than an underlying increase in debt burdens. Even so, it appears that households, like businesses, have become more willing to take on debt, at the expense of more vulnerable financial positions.

Shifting attitudes toward debt

The reasons for the apparent shift in attitudes are not easily identified and quantifiable. It is evident that the tax system favors debt over equity sources of funds for businesses through its differential treatment of interest and dividend payments. It also encourages household borrowing by allowing unlimited deductions for interest expenses. However, these provisions and their incentives have not substantially changed in the 1980s, and lower marginal tax rates tend to reduce the incentives.

The inflation experience of the 1970s probably had a profound effect on attitudes toward debt. During much of that period, inflation rates outstripped interest rates, making leveraged buying a seemingly attractive economic strategy. Some borrowers may have expected inflation to pick up again as the

Household debt and principal components (Relative to disposable personal income)



Note: Shaded areas indicate periods of recession.

economy expanded after 1982, inducing them to buy in advance of price increases and in anticipation of repaying debts in dollars of lower real value. Perhaps they looked to some degree to the borrowing patterns of the federal government as justification of a view that debt creation is benign.

This tactic might have seemed quite risky and unattractive if borrowing had to be done at the high long-term rates prevailing over this period. But the greater availability of short-term and floating-rate instruments reduced the risk considerably, since if inflation did not rebound, short-term rates would be expected to move lower.

The shift to floating-rate instruments is but one example of innovations in financial markets that have played a role in supporting, if not encouraging, the growth of debt. The proliferation of techniques such as interest rate swaps, securitization of loan portfolios, and

third-party guarantees may have given borrowers access to sources of funds that might otherwise have been closed to them, and reduced perceptions of risk. Many smaller or growing companies have long used low or unrated bonds as an important financing technique, and those securities clearly have a legitimate role in finance. But recent innovations, relying on the use of such bonds to finance large takeovers of well established companies, seem to have opened new channels from lenders to borrowers, increasing the flow of credit for particular uses.

For intermediaries, the rapid development of secondary markets at home and abroad for loans of various types has enabled them to originate a far larger volume of credit than would be consistent with their own command over resources. In addition, concerns over exposure to interest rate fluctuations probably do not constrain asset growth at banks or

thrifts to the degree they once did, given the greater opportunities to structure both assets and liabilities to manage the degree of interest rate risk.

At the same time, elimination of most deposit rate ceilings allows depository institutions to compete for funds for lending under a variety of circumstances, even if interest rates were to rise sharply. And the lifting of many usury ceilings has meant that lenders would continue to be willing to make credit available under such conditions. Thus, deregulation has substantially diminished the threat of constraints on credit availability as credit markets tighten, though it may also imply a wider swing in interest rates over the cycle.

From one perspective, these developments have increased the efficiency of our credit markets and improved the distribution of savings among competing uses. The greater variety of instruments available enables borrowers to tailor the maturity and other characteristics of debt to their specific needs or expectations. And with deregulation, borrowers probably feel a greater sense of assurance that funds will be available to roll over existing debt, even if interest rates should rise. On the supply side of the credit market, the ability of intermediaries to reduce interest rate risk, to compete for funds without regulatory constraint, and to replenish lendable funds through sales of assets probably has encouraged a more aggressive pursuit of lending opportunities and an eager embrace of innovative techniques to appeal to borrowers.

Consequences and concerns

On balance, the net effect of shifting attitudes and financial innovation appears to have been to increase the expansion of private debt. Many of the particular techniques developed are designed to reduce risks for one or more of

the parties directly involved. The larger question remains as to whether risks have, in fact, been reduced on balance for the financial system and the economy as a whole. The increase in total debt burdens, the longer and larger chain of transactions between ultimate borrowers and lenders with a diffusion and possible widening of credit judgment, the greater internationalization of the system all raise questions.

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One thing seems reasonably clear. More of the risk of unexpected movements in interest rates has been shifted onto borrowers. Most recently, borrowers have benefited from this shift, as declining interest rates have reduced their interest costs and enabled them to extend debt maturities at considerably lower rates than if they had been using long-term credit all along. But the strategy can, and does, carry considerable risk that an unanticipated rise in interest rates could sap the financial strength and creditworthiness of a substantial number of borrowers.

My general concern relates primarily to the degree to which the continuing buildup of debt may, as a byproduct of eroding financial positions, leave a substantial number of borrowers so extended that they would have great difficulty dealing with unanticipated financial setbacks. Of course, borrowers ordinarily do not take on debt they expect, with any high degree of probability, will cause them problems ahead (although even that assumption may not be valid with respect to a relatively few depository institutions in hard-pressed financial circumstances that have been willing, in effect, to make high-stake gambles with insured

depositors' money). Nonetheless, the larger the share of income devoted to debt servicing in relatively prosperous times or the smaller the equity cushion—and that has been the trend over rather a long period of time—the more likely it is that an unexpected shortfall in income or rise in interest rates will lead to problems in meeting obligations.

For individual borrowers, income could weaken owing to factors beyond their control, reflecting conditions in a particular region or industry as well as a general downturn in the economy. A substantial rise in interest rates could prove especially troublesome, given the still heavy reliance on short-term or floating-rate debt. Many borrowers may minimize such possibilities—and economic policy typically works to limit the risk. But all of history suggests it would be shortsighted to behave as if such possibilities did not exist.

The agricultural sector of our economy provides ample evidence of the effect of unexpected developments on highly leveraged borrowers. Those farmers who went deeply into debt in the late 1970s in anticipation of maintenance of higher land and crop prices are experiencing the most agonizing difficulties as these expectations are not fulfilled. Their problems in turn have severely weakened a number of agricultural lenders.

Potential vulnerabilities are suggested not only by elevated debt-to-income ratios throughout the economy, but also by the deterioration or disappointing performance of certain more direct indicators of financial distress at a time of rising economic activity generally. Corporate bond downgradings, for example, have trended sharply higher over the past two years, reflecting in part concerns about the effects of additional leveraging on the financial strength of certain corporations. In addition, problems in the household sector are indicated by some upward tendency in delin-

quency rates on consumer and mortgage loans or other measures of financial distress during the expansion period.

In another vein, I addressed earlier some of the implications of our growing dependence on capital and credit from abroad. That is hardly a dependable source of financing for years to come and indeed will shrink as our trade balance improves, as we hope.

I do not suggest that these developments point to some inexorable accumulation of debilitating financial difficulty. Indeed, there are a number of developments currently working in the opposite direction. Recent substantial declines in interest rates and increases in stock prices have helped to alleviate pressures on financial positions. The fall in rates by itself will reduce debt-servicing burdens, and both firms and households have taken advantage of the considerable downward movement in long-term rates to lengthen the maturities of their liabilities, locking in lower rates and reducing exposure to an unanticipated rise in short-term rates. The higher stock prices are currently strengthening the financial positions of many individuals and companies. New stock issues have picked up. And recent regulatory and supervisory initiatives can help.

At the same time, enough has gone on, and continues to go on, to raise clear warning signals, to justify further analytic effort, and to support action in areas where such action is plainly warranted.

Addressing the concerns

We know enough to understand that disproportionate increases in debt extended over the years do not constitute a solid, sustainable base for satisfactory economic growth and stability indefinitely into the future. Ultimately, debt can only be serviced from income. If that relationship is strained, financial pressures

will jeopardize further growth in income itself, aggravating the difficulties. The time to act is before the strains become oppressive, not after.

The most direct step that can be taken by the government itself to address concerns about the growth of debt is to decrease, and eventually eliminate, the federal budget deficit. Such a course will reduce pressures on domestic credit markets, freeing domestic savings to be channeled into domestic investment and encouraging further restructuring of balance sheets through greater reliance on long-term debt and equity. By promoting better balance between spending and income domestically, it will also work to reduce dependence on foreign capital.

Some of these effects already were discernible as the Gramm-Rudman-Hollings legislation moved toward passage late last year; the improved outlook for budget balance appeared to contribute materially to the decline in rates on bonds and fixed-rate mortgages, in an environment in which the dollar was also depreciating toward levels more consistent with restoring the international competitive position of U.S. products. Concrete actions to implement the law will provide a constructive background for financial markets over coming years, partly by its direct effects and partly by reducing the chances of a resurgence in inflationary pressures.

Beyond that step, I believe the time has come for Congress to also address those elements of our tax code that so strongly favor debt finance. While that "bias" has long existed, other changes in the economic and financial environment seem to have had the effect of making it more important in decision making.

The original Treasury tax reform proposal had some limited elements that moved in the right direction; they have subsequently been

dropped or sharply diluted. One lesson, I suppose, is that no strong constituency has emerged for a reform with such diffuse and seemingly indirect benefits. But I also believe that other efforts to reduce excessive reliance on debt in the private sector pale into relative insignificance so long as that basic bias imbedded in the tax system exists.

I noted that deregulation and innovation may encourage growth of debt. Those changes respond to basic technological and competitive forces that cannot be denied. We can, however, respond in constructive ways, strengthening, when necessary, oversight of key markets and intermediaries so that they do not become the unwitting vehicles for the spread of problems through the economy.

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To this end, the Federal Reserve, working in concert with other regulators of depository institutions, has stepped up its examination of banks and bank holding companies, tightened capital standards, and proposed keying those standards to the risk profile of the banks. We and the other bank regulators are also acting to deal with present points of strain, particularly in the agricultural and energy areas, through a variety of techniques. We have also joined with the other regulators in requesting that Congress extend and liberalize legislative authorization for interstate acquisition of troubled institutions.

These are essentially defensive measures designed to keep immediate problems from infecting the financial system more generally by easing adjustments in individual institutions and local areas. These measures are not, and cannot be, a substitute for forward-looking structural change.

In that connection, it seems to me impera-

tive to clarify and modernize the laws governing the structure of our depository and financial systems. Too often in recent years, old legislation has clashed with new market facts. Accommodation is achieved more by the exploitation of perceived loopholes in existing law than by a well-considered design of how we want the financial system to evolve. Distinctions among banking, other financial institutions, and commercial firms are fast eroding and there is little considered debate—and less action—to guide the process.

For a long time, as the result of the lessons of past financial crises, the unique role of banking and the payments system in our economy has, in concept, been recognized through provision of a federal “safety net,” backed up by special oversight and supervision. Today, the distinctions underlying that approach are rapidly eroding, raising new questions about our ability to maintain the stability of the whole. The situation cries out for review and for new laws, adapted to the problems of today and tomorrow.

Nor can we evade a review of the basic safeguards and trading practices in other key sectors of financial markets, given the complex interdependencies that exist. One specific example came to your attention last year, and the Committee responded by providing a legislative framework for limited surveillance and regulation of the government securities market. As you know, action has not yet been completed on that matter.

Conclusion

In one sense, the extraordinary volume of credit flows in recent years is a tribute to the efficiency and innovative instincts of financial intermediaries, borrowers, and lenders alike. There has been rapid and effective response to new technological possibilities.

Those same developments also highlight the complex interactions involved and the new interdependencies created. And, in the end, credit creation is constructive only to the extent that the obligations are manageable in relation to income.

It is in those areas that questions arise.

I must emphasize that the government can take a number of basic steps to address concerns about the rapid growth of debt. These include, most importantly, a balanced approach to economic policy, including cutting excessive budget deficits and a fresh look at some important provisions of the tax code. Government must also provide a supervisory and regulatory structure to promote a sound financial system.

Ultimately, and quite properly in our free market economy, the strength of our financial system must also ultimately rest on the prudent decisions of private parties. Borrowers and lenders must recognize risks and act to manage them. In such a context, the growth of debt would hold no concerns for us, but rather would be seen as an integral part of a healthy and active economy.