Commentary On "Debt Problems and Macroeconomic Policies"

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Before I read Larry Summers' thoughtful the paper on the domestic debt non-crisis, I had the vague impression that worries about explosive growth in the ratio of the Friedman measure of credit to gross national product (GNP) were excessive because:

(1) Most of the growth came from government debt, not private debt. ,
(2) If there are more debt liabilities, there must be correspondingly more credit assets.
(3) More credit may well be good, not bad, for the economy for a variety of reasons.
(4) Financial distress seems not to be generalized, but rather concentrated in sectors—like farming and energy—which have suffered from specific adverse shocks.
(5) And finally, the ratios of other credit aggregates to GNP were never as constant as was the Friedman measure—which received so much attention precisely for this reason.

Each of these beliefs save the last (about which more presently) was ably supported in Larry's paper, which leaves me little to disagree with. And that, of course, raises the danger that this will be a boring discussion. I will try to avoid that by highlighting some points of difference, for I do think that Larry leaves out some aspects of the debt problem that should be mentioned. But this academic quibbling should not obscure the basic message that Larry's views and my own are very similar.

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I will organize my remarks around five basic questions asked and answered by Summers.

Why has the debt ratio risen? What does it mean?

Larry points out that while the time series plot of Friedman credit relative to Y (henceforth, FC/Y) shows a sharp break with historical experience in the 1980s, the corresponding plot of private borrowing relative to GNP does not; it simply continues its upward march. So, in Larry's view, there has been no explosion in private debt. What happened, instead, is that the formerly steady downward drift of government debt relative to GNP was reversed, and so no longer offset the rise in private debt. Larry is inclined to view it as a coincidence that, relative to GNP, government debt was falling as fast as private debt was rising before 1980. And he buttresses this view with time series regressions showing little if any systematic negative relationship between the two.

I am inclined to agree and would add two related observations. First, the ratio of FC/Y was not constant, but rather rising rapidly, during the 1952-61 period. It was only constant during the 1960s and 1970s. (Ben Friedman will no doubt point out, correctly, that 20 years is nothing to sneeze at.)

Second, as I mentioned, other measures of credit were always growing faster than GNP, even in the 1960s and 1970s. For example, Chart 1 shows the behavior of a broad measure of total borrowing in U.S. credit markets that I have developed elsewhere, called B.[1] Except for a brief period in the late 1960s, when unanticipated inflation reduced the real value of debt while real GNP boomed, the ratio B N has always grown. The 1980s look no different from earlier history. (Regrettably, I have not yet brought this series beyond 1983.) The chart also shows the ratios to GNP of total borrowing by households (BH/Y) and by nonfinancial businesses (BB/Y). Business borrowing relative to GNP certainly shows an unbroken upward march. Intriguingly, household borrowing relative to GNP shows a pattern similar to Friedman credit: growth until 1965, a decade or so of constancy, and then resumption of growth.

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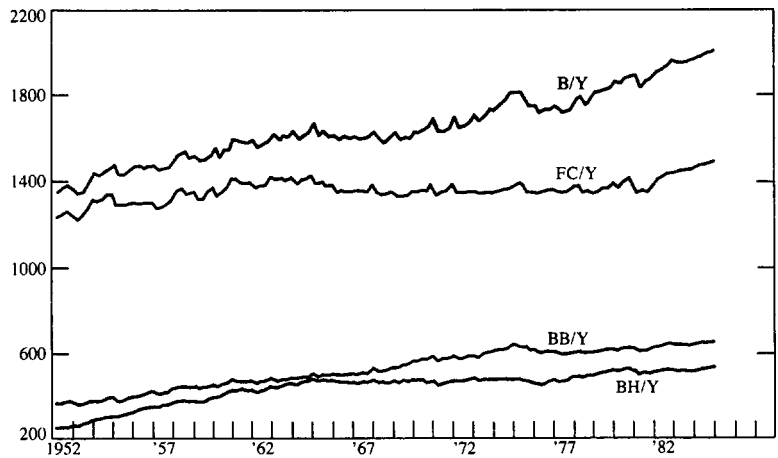
[1] The series is described in Blinder (1985). It is broader than Friedman's credit measure in that it includes foreign as well as domestic borrowers, some borrowing by financial institutions, and a bmader array of financial instruments than Friedman allows (e.g., especially trade credit and large time deposits).

CHART 1
Ratios of Credit Aggregates to GNP



Larry stresses that private and government debt are fundamentally different. That is true. But he goes a bit too far when he says that any debt of the private sector must be balanced by an equivalent private asset because "private debt is a purely inside obligation." In fact, in 1983:IV (the last quarter of my data), foreigners and the government together accounted for fully 21 percent of total lending in U.S. credit markets. This percentage must be higher today.

Does the rising private debt ratio pose a macro problem?

Summers says no. First, it is net worth, not debt, that matters for solvency questions. Second, whatever financial problems we have are sectoral not macroeconomic. But Friedman seems to disagree. (It is nice to see that diversity still thrives at Harvard after 350 years!) Here I am going to be one of those awful two-handed economists and argue that Larry goes too far in claiming that Ben is a worrywart. I have two reasons.

First, man does not live on stocks alone; flows also matter. Higher real interest rates probably imply lower optimal ratios of private debt to GNP. At least I felt more comfortable with a huge mortgage when real interest rates were negative than I would now. Even if the suggested negative relationship between real interest rates and optimal

debt ratios is not accepted, it is certainly true that higher real rates imply higher probabilities of default for any given debt-GNP ratio. Since real rates are much higher in the 1980s than in the previous three decades, the fact that private debt-GNP ratios have continued their inexorable upward march may be worrisome. When I read Larry's paper, I vowed to compute the ratios of household and business interest payments to the relevant income flows to see if they were rising faster in the 1980s than before. Fortunately, Ben Friedrnan's paper arrived the next day and saved me the work (see his Chart 2). Nominal household interest payments rose from 2.5 percent of disposable income in 1953 to 7.6 percent in 1984, though without any noticeable acceleration of this trend in the 1980s. I trust, however, that if real interest payments were used instead, the rise in the 1980s would be far greater. Business interest payments relative to earnings rise dramatically on Friedrnan's chart starting in the late 1970s, and now exceed 50 percent for nonfinancial corporations and 30 percent for noncorporate business. I think these numbers are more relevant to the issues of financial distress and macro stability than Summers apparently does.

The second reason is related to the first. If Irving Fisher (1933)—or my colleague Ben Bernanke (1983)—were here today, he would probably let the words "debt deflation" pass his lips. When inflation falls more rapidly than expected, borrowers are saddled not only with higher-than-anticipated real interest payments but also with higher real repayments of principal. Some will be unable to pay. This has certainly happened to some substantial extent in the United States in the 1980s and has contributed in no small way to the rise in debt defaults shown in Friedman's useful Table 6. It is a story, I think, that it not unknown within the boundaries of the Kansas City Federal Reserve district.

Rising real interest rates and debt deflation pose general macro problems, not sectoral ones. They are part of the legacy of conquering inflation through tight money. I think Summers pays them too little respect.

Is debt useful as a macroeconomic indicator?

Larry is skeptical. He points out, first of all, that a rise in debt could be either a positive or a negative indicator of economic activity. True. He also says that "credit availability theories would sug-

gest investigating much narrower aggregates linked to the parts of the financial system where credit might plausibly be rationed," rather than using Friedman credit. Again I agree and can report the following. Take each component of total borrowing (as I have measured it) for the period 1952-83, deflate by the GNP deflator, and detrend. Then the contemporaneous correlations with real GNP, using quarterly data, are as follows:*

Consumer credit	0.80
Mortgage credit	0.64
Security credit	0.61
Loans (by banks and others)	0.57
Trade credit lending	0.44
Bonds	0.29
Commercial paper	0.13
Large CDs	0.08

This ranking, I think, accords quite well with Larry's expectations.

As a second question, we can ask what sort of credit aggregate (in nominal terms, now) is the best predictor of future nominal GNP movements. I tried the following:

Total borrowing	0.246
Friedman credit:	0.032
Bank credit:	0.027
Borrowing by households:	0.025
Borrowing by nonfinancial business:	0.104
Intermediated borrowing by households:[3]	0.046
Intermediated borrowing by nonfinancial business:[4]	0.190

In each case, using quarterly 1953-83 data, a Granger causality test was run using four lags of nominal GNP and four lags of the credit aggregate. The results of F-tests for excluding the credit aggregate are shown in the listing above by reporting the marginal significance levels. (I was surprised, given Ben Friedman's well-known results, that bank credit edged out Friedman credit.) The general message in these results is more or less as Larry and I expected: credit subject to rationing generally has more predictive power than open-market credit.

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2 Blinder (1985), Table 7.

3 Borrowing in the forms of consumer credit, mortgages, loans, and trade credit.

4 Borrowing in the forms of mortgages, loans, and trade credit.

Does the rising government debt ratio pose a macro problem?

Summers' answer here is a resounding yes, though he adds that the problem is not that large government deficits either increase the fragility of the private financial system or influence the level of GNP. Instead, Larry insists, the real problem is that large deficits have a profound effect on the composition of GNP, especially by crowding out investment. I'd like to demur somewhat from each of these points.

The first demurral is actually Summers' own; but you may have missed it since it goes by in a single paragraph. Since I think it's quite important, I'd like to call it to your attention.

Larry argues cleverly that the sectoral imbalances caused by large government deficits raise the variance of the distribution of financial health in the economy. Since it is only the lower tail of this distribution—the part where default is a real possibility—that matters for financial distress, the federal deficit therefore raises financial fragility. This story rings true—loudly true. Surely, the financial distress in the farm belt and the export-damaged parts of the manufacturing sector are traceable in no small measure to the Reagan tax cuts.

Larry argues that fluctuations in government deficits have little impact on GNP—not for Barro-type reasons, but rather because the Fed is targeting nominal GNP and, therefore, offsetting the impact of fiscal policy on aggregate demand. I think that is probably roughly right, though a bit exaggerated. But I think it is also a very recent policy stance for the Fed. It certainly does not characterize 1980-83 very well. How long it will last is anybody's guess. Well, as I look around the room, perhaps not anybody's. But I hesitate to enunciate it as a general principal.

Finally, I have some troubles with the view that government deficits mainly crowd out investment. First, it has proven quite difficult econometrically to detect systematic and strong effects of deficits on interest rates. And if deficits do not push up real interest rates, it's hard to see how they could damage investment. Here, I am not saying I disagree with Larry, only that he should qualify his conclusion a bit more.

Second, I think he gives insufficient emphasis to the likelihood that crowding out has shifted lately from investment to net exports. Table 1 is taken from a recent paper of mine (Blinder, 1986), but you have all seen similar tabulations. Compare the average of 1984 and 1985 with the average for the 1970s. It shows that fixed investment as a

TABLE 1
Composition of Real Final Sales
(percent)

Component	Average 1970-79	1980	1981	1982	1983	1984	1985
Consumer expenditures	63.2	63.2	63.2	64.3	65.4	65.4	64.8
Fixed investment	15.8	16.3	16.2	14.8	14.9	16.4	16.6
Business	10.8	11.8	12.2	11.5	10.5	11.5	11.9
Housing	5.0	4.5	4.0	3.3	4.5	4.8	4.7
Government purchases	20.3	19.4	19.4	20.1	19.8	19.9	20.4
Net exports	0.8	1.2	1.1	0.8	−0.2	−1.6	−1.9
Exports	9.1	12.8	12.6	11.3	10.4	10.4	9.3
Imports	8.3	11.6	11.5	10.5	10.5	12.0	11.2

share of real final sales was actually higher by 0.7 percentage point even though consumption's share was higher by 1.9 points. What was crowded out, apparently, was net exports, whose share of real final sales fell by about 2.6 points. This is a very different story from Summers' regressions which, as he says, are dominated by pre-1980s data. It is a story that helps explain why the American public has been so complacent about the deficits. If investment as a share of GNP had declined by 2 percent, all hell would have broken loose! And, in view of the high degree of international capital mobility, it also helps explain how deficits can cause severe crowding out without causing large apparent increases in real interest rates.

Does the tax structure encourage excessive use of debt?

Summers says yes — which, of course, is the right answer. And he uses this answer to get in yet another plug for his favorite tax: the consumption tax. I do not disagree with Larry but would, instead, use the same pretext to get in a plug for my favorite reform: indexing the income tax.

Larry is correct that any income tax will subsidize debt financing because people will arrange things so that borrowers are in higher tax brackets than lenders. No income tax reform will be able to prevent this entirely since there will always be different marginal rates; at a minimum, there will always be untaxed lenders. However, I think Larry underestimates the good that will be done by the new tax bill.

First, as he knows, the amount of extra borrowing induced by the tax system depends on the gap between the marginal tax rates of lenders

and borrowers. The compressed structure of marginal rates will shrink this gap. After all, a 33 percent tax rate really is 34 percent lower than a 50 percent tax rate. Second, I don't think the limits on interest deductions will be quite as irrelevant as Summers says, though they surely will be avoided to some extent.

A consumption tax would end the tax distortion in favor of debt, as Larry says. But indexing would eliminate a good deal of it without overthrowing the basic framework of income taxation that we have just worked so hard to improve. How much of the job would indexing do? That depends on the relative sizes of real interest rates and expected inflation since the distortion under the income tax applies to the nominal rate and indexing would just reduce the base of the distortion to the real rate, not eliminate it entirely.

Actually, if you work through the algebra, the fraction of the overborrowing problem cured by indexing turns out to be $\dot{p}/i^*$, where p is the (actual=expected) inflation rate and i* is the hypothetical nominal interest rate that would prevail in the absence of tax distortions. This ratio is bigger than you think, even with today's high real rates, because i* is necessarily smaller than the actual nominal interest rate under present tax laws, i. Specifically, the ratio of i/i^* can be shown to be $1/(1-t)$, where t is a weighted average of the tax rates on borrowers and lenders? Thus, the fraction of the problem cured by indexing is $\dot{p}/i(1-t)$, which is large even if i greatly exceeds p. For example, let $i=0.08$ and $\dot{p}=0.04$ (a real rate of 4 percent). Then $t=0.25$ implies that indexing cures 67 percent of the problem. That sounds pretty good to me.

Conclusion

I agree with Larry that rising debt-to-income ratios are worrisome primarily when the denominator is falling rather than when the numerator is rising—and that such occurrences usually have sectoral, not macroeconomic, origins.

But I would add, as he did not, that rising ratios of interest obligations to income are a general macroeconomic headache, even when they come from the numerator, and that they can pose threats to financial stability. The solution here is obvious: the Federal Reserve should

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5 The weights depend on the semi-elasticities of lending and borrowing and are equal if these elasticities are equal.

reduce real interest rates. I will bet our hosts have heard that before, even from me. And they will hear it again.

In addition, sectoral imbalances caused by the effects of federal deficits on relative prices like real interest rates and the terms of trade are quite serious. And, they interact with financial fragility problems in ways that I had not thought of until I read Larry's paper. I thank him for pointing it out. Now, if only someone would tell President Reagan.

References

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