

Commentary on "Debt Problems and Macroeconomic Policies"

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There is general agreement that debt in the U.S. economy relative to income or gross national product,(GNP) has grown enormously in recent years, and perhaps dangerously. I shall comment on **Sumner's answers** to the two questions, "why has it grown?" and "so what?" It helps to consider "so what?" if we can first understand why.

Why?

Summers quite properly differentiates federal government and private debt. The risk of default differs substantially, being virtually nonexistent for federal debt. Furthermore, he concludes that federal debt has not reduced private debt issues, contrary to the idea that an **offset** between federal and private debt could explain the long stability in the ratio of total debt to GNP. Let me comment briefly on that.

The correlation coefficients in his Table 1 show that total government debt has no **systematic** negative relationship to deviations of private debt from trend. The implication of no effect is less than conclusive, however. **His** Table 2 correlations, presented for a different purpose, show that federal deficits reduce private investment and raise saving, though less than dollar for dollar. If much of private debt is **generated** to finance investment expenditures, Table 2 would appear to imply, even though it is based on flows, a corresponding negative relationship between stocks, contrary to the Table 1 result of no relationship. But Table 2 is not without its problems too. Standard theory implies that any observed effect of deficits on investment occurs through an intermediate effect on interest rates. Yet there are more studies in the literature (at last count) showing no such effect than

there are studies that claim to find it. How do we cut our way out of this maze of contradictory findings?

Since federal and private debt **are** substitutes to an extent, an increase in the supply of federal debt should partially but not inconsequentially increase the interest cost and reduce the supply of private debt. Historically, however, before the **1980s**, such an effect was dwarfed by other cyclical developments so that quantitatively it is a "needle in a hay stack." Our econometric tools often cannot find pitchforks much less needles and cannot always be taken seriously. Therefore, I think it is best to conclude that federal debt crowds out private debt to some extent, though not necessarily by enough to explain the past constancy of the ratio of total debt to GNP.

According to Friedman's Table 1, the government, including state and local entities, accounted for almost half the total increase in U.S. debt from 1980 to 1985. The increase in federal debt requires a political explanation, which seems straightforward. The private increase, however, requires an economic explanation that is not so simple.

As Summers and **Friedman** point out, the net worth of the private sector has changed little relative to GNP; that is, assets stand behind the growth of liabilities. Businesses and households have borrowed to acquire assets rather than to finance consumption, although household consumer durables formed nearly a third of the increase in their part of tangible assets. We should remember that, during the **1970s**, the public sought hedges against inflation and nonequity financial assets held by the private sector, excluding financial intermediaries, actually fell relative to the market value of tangible assets. Then in the **1980s**, this shift to tangibles reversed and the ratio of financial to tangible assets for the whole economy is now almost back to the normal level represented by the 1960s.

This reversal mainly reflects a rise in the market value of tangibles, and partly because of this rise, borrowing has favored debt over equity to restore the desired ratio of financial to tangible assets. Nevertheless, this reversal does not explain the continuing growth of debt relative to income. Household debt relative to income has trended upward for many years. Yet Friedman's Chart 2 shows household interest payments as a percentage of personal disposable income at only 7.6 percent in 1984, with no major change in the upward trend in the past three decades. This steady upward trend can probably be explained by demography, an increase in homeownership and appliances per household, and the credit card revolution. It has far to go before it threatens the financial stability of the economy. Moreover, it should

ease as lower interest rates work through the mortgage stock.

It is the growth of debt and interest payments of business that stands out. In Friedman's Chart 2, this growth begins in the mid-1960s with the Vietnam inflation and escalates with disinflation in the 1980s. Summers points out that the ratio of business debt to **GNP** has long followed an upward trend with little significant deviation. Although interest payments grew even faster after the **mid-1960s**, which may have happened only because interest rates rose, that leaves unexplained the continued high interest payments in the 1980s as rates declined sharply.

First, why the upward trend in business debt? Summers cites the tax advantages of debt. Corporations have gradually shifted from equity to debt financing. The additional growth of noncorporate debt, I presume, reflects **mainly** the tax advantages of real estate investment. And state and local governments also have a tax angle. As **Friedman** notes, they have sold tax-exempt municipals to invest in higher yielding Treasuries. Summers, nevertheless, questions the quantitative importance of taxes for corporate debt on grounds that further tax advantages in the past decade did not accelerate the shift to debt. But taxes may explain part of the upward trend in the corporate debt ratio, which otherwise would not have continued rising if the set of tax advantages had remained unchanged. **As** further explanation for part of the recent rise in the corporate ratio, we have the junk bonds, though they may reflect more than a tax advantage. As I understand it, those crazy zero-coupon junk bonds find a market with financial intermediaries that want to report large accounting incomes and can shift the dangers of default to government insurance. That, incidentally, represents a hazard for the taxpayer **rather** than a direct threat to **financial** stability, and pleads for a reform of government insurance programs rather than new restrictions on security issues.

Friedman informs us that almost all the increase in corporate debt from 1980 to 1985 reflected mergers, acquisitions, and leveraged buyouts in the final two years. We can attribute a good part of this mania of corporate reorganization to the maladjustments produced by inflation. For reasons not entirely clear, the market value of equity did not keep up with inflation, and the ratio of the market value of firms to their capital replacement cost declined sharply after 1972. It thus became much cheaper to buy old than new capital. The value of this ratio, known as **Tobin's q**, fell as low as one-half, and **economic** logic tells us that something unusual was bound to result from this unprecedented situation. It is one of many legacies of the escalating

inflation of the 1970s.

Based on these conjectures, corporate reorganizations and their junk bond progeny will subside as Tobin's q approaches unity. The ratio had recovered to 60 percent at the end of 1985 and improved considerably further with the market's 20 percent rise so far in 1986. In addition, the new tax law of 1986 should restrain the growth of real estate debt, and the unchanged tax advantages of corporate debt should put a limit on the debt-equity ratio, though when is unknown. In any event, as my colleague Herb Stein points out, if a trend cannot, by economic logic, go on indefinitely, it will eventually stop! Of course, to paraphrase the issue of this conference, the question is, under what circumstances will it stop?

So what?

Let me turn to Summer's answer to "so what?" If the increased debt has assets behind it as indicated by stable net worth ratios, most issuers are not insolvent and presumably are reasonably protected against default. Yet the increased leverage produced by shifts from equity to debt can result in cash flow and liquidity problems. Friedman notes that the liquid asset holdings of corporations have not increased to match the growth in debt, and the liquid asset position of noncorporations has deteriorated. He fears that the periodic need for monetary restrictions faces increased risks of precipitating liquidity crises, which gives the Federal Reserve less elbow room to combat inflationary pressures.

Looking at these same data, Summers appears to be less pessimistic. Obviously, there is room for disagreement on the future consequences. Forecasting financial crises ranks on a par with economists' ability to predict the stock market. Although the dangers of overindebtedness are clear enough and foster pessimism, a review of the data gives some grounds for guarded optimism, though presumably not complacency. Let me list four:

(1) The government debt is safe, though its growth carries undesirable burdens on the economy of other kinds, which I return to in a moment.

(2) The net worth of households and businesses has not deteriorated. Although some could be short of liquid assets, the danger of an unsatisfactory allocation between short and long-term assets differs from the danger of excessive total debt.

(3) Holders of junk bonds must know the risks and be prepared for them. Therefore, default need not produce externalities for finan-

cial markets, though part of the damage may fall on taxpayers through insurance programs.

(4) Debt problems have already taken their toll for several years as a result of overborrowing during inflation in the 1970s and disinflation in the 1980s. Bankruptcies have been running far above normal, particularly in the farming and oil-related sectors, not to mention the demise of thrift institutions and the unservicable international debt of many foreign countries. These actual and near bankruptcies are affecting banks, but we have had no spreading financial crisis. So far, the financial system appears capable of weathering these disasters if they do not happen all at once but slide down gradually, especially if well lubricated with government subsidies.

I am inclined to agree with Summers that our excessive debt poses micro rather than macro problems and should be addressed as such, particularly the incentives to issue debt rather than equity. Treating the two equally in the tax system, such as making dividends tax deductible, would work wonders. While we are concerned here with potential financial crises that may never materialize, the economy has already paid dearly for the micro problems of overindebtedness. In addition to the distress in farming and oil and the Third World, Treasury debt issues from the U.S. budget deficit produced a massive trade deficit that has exacerbated the farm problem and pushed **many** U.S. **foreign-**competing industries to the wall. Having faced these micro disasters, surely monetary policy will not transform them into a macro problem by adopting an inflationary bias to avoid the default of a few junk bonds. At least, I hope we have our priorities straight. Extricating the economy from 15 years of escalating inflation has been no picnic. Monetary policymakers will not want to face the necessity of going through that experience again.

Consequences for monetary targeting

Of course, policymaker can make mistakes. As a final point, let me comment on the problems of conducting monetary policy. The unpredictable behavior of monetary velocity, particularly since 1980, has increased the possibility of unintended policy outcomes. It is interesting **to** note that Henry Simons, an earlier University of Chicago guru on monetary policy issues, lamented the growth of debt as inimical to a sound monetary system, but it was the growth of short-term debt that concerned him. He wanted a financial system composed of money and long-term debt only, so that the public was unlikely

to want to shift between money and close substitutes, which create unpredictable changes in the demand for money. Simons did not see long-term debt as posing a problem for the conduct of monetary policy because it was not held for liquidity and because defaults were not a major problem if they did not disturb the money stock. How times have changed. No one mentions the growth of short-term debt anymore.

Yet, it is short-term debt that has created problems for monetary targeting and made the conduct of policy more difficult. While the recent growth of the debt-GNP ratio seems to suggest that this growth is related to the decline in monetary velocity and that the change in behavior of monetary velocity seems not to reflect simply the growth of short-term debt, I do not see a connection between the growth of debt and money. The fact that the public is holding more debt does not imply an increased demand for money. The different behavior of M2 and M3 velocity suggests different forces at work on liquid rather than long-term assets. Indeed, the decline in monetary velocity since 1980 appears attributable to the decline in the opportunity cost of holding money, particularly interest-bearing NOW accounts. I find in my work that the problem of estimating a money demand equation that can be used for prediction in the 1980s results from the poor fit of the equation to the second half of the 1970s. That was a period of change, and we need a decade or two **beyond** those years to estimate a new equation. Whether money or debt will sometime find favor again as targets for monetary policy are unrelated questions. I think money will. I have serious doubts about debt.