Debt: The Threat To Economic and Financial Stability

By Henry Kaufman

I was pleased to have received an invitation to be the leadoff speaker at this conference to present an overview of the current debt situation in the United States and of financial stability. It was in the late 1960s when I first detected that developments in debt creation might be taking an ominous turn. Since then, I have spoken about the subject a number of times. While many debt problems have surfaced in recent years, the issue of debt and financial stability does not yet have the national attention it so crucially deserves. Now, the problems associated with debt are well past their infancy and, indeed, are dangerously full grown. Even so, there is still only some awareness today that debt has both a sunny and a dark side to it. Historically, the act of creating debt contributed to economic and financial exhilaration. But in the past several years, we have realized that the obligations inherent in debt may impose hardships on lenders and borrowers and, indeed, on the economy and the financial markets as a whole.

The reality is that our debt problem is not going to go away. It is complex; there are no easy solutions. To cope successfully with this problem and stave off an economic disruption of major proportions, the role of our financial system will need to be redefined and structural changes and disciplines that are lacking today will have to be imposed. Unfortunately, there is as yet no evidence that adequate measures will be undertaken soon to ameliorate this situation.

The many dimensions of the debt problem

The debt problem has many dimensions. Most noticeable—and most talked about—is the rapid growth of debt. At the end of 1985, total credit market debt—mainly households, businesses, and governments, but also the financial sector—totaled $8.2 trillion, compared with $4.6 trillion at the start of the decade and $1.6 trillion in 1970. As shown in Table 1, total debt rose annually by 7.25 percent in the 1960s, by 11 percent in the 1970s, and by almost 12 percent so far in the 1980s.

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TABLE 1
Growth of nominal GNP versus credit
(Average annual percentage of change)

	1960s	1970s	1980-85	1985	Billions of dollars[1]
Nominal GNP	6.89	10.06	8.07	5.67	3,998.10
Domestic nonfinancial debt	6.83	10.40	11.58	15.00	7,131.90
Corporate	9.40	11.22	10.39	12.40	1,505.10
Household[2]	8.55	11.40	10.30	12.85	3,224.60
U.S. government	1.96	8.83	15.84	16.24	1,660.40
State and local government	7.55	7.39	12.47	34.18	553.10
Foreign debt in the U.S.	8.57	14.42	5.54	0.61	1,115.60
Financial debt	14.94	16.78	15.69	21.03	248.90
Total Debt	**7.25**	**11.06**	**11.75**	**15.23**	**8,247.50**

1 As of December 31, 1985
2 Household sector includes farm and nonfarm corporate business.

Debt expansion is also outrunning gross national product (GNP) growth. Credit market debt outstanding at the end of last year exceeded nominal GNP by a ratio of 2 to 1. In 1980, debt was 70 percent higher than GNP, and in both 1960 and 1970, it was roughly 50 percent higher than GNP.

All major sectors of the economy have accelerated their use of credit. Corporate debt, for example, increased by 12.4 percent in 1985, compared with 9.4 percent annually in the 1960s. Household debt rose by 12.8 percent in 1985, up from an annual average increase of 8.6 percent in the 1960s. But the most dramatic stepup in borrowings by far has been incurred by governments: U.S. government debt rose at an annual rate of 2 percent in the 1960s, by 9 percent in the 1970s, and almost 16 percent annually thus far in the 1980s. Concurrently, state and local governments debt expanded by around 7.5 percent annually in the 1960s and 1970s and then jumped to 12.5 percent per year thus far in the 1980s. Debt has also burgeoned internationally. At the end of 1985, the medium and long-term external debt of less developed countries totaled $781 billion, or 159 percent of their gross merchandise exports, compared with $173 billion, or 73 percent of their merchandise exports, in 1975.

A significant deterioration in the quality of credit has accompanied this swift debt growth. In the United States, this has been most noticeable in the business sector, where more credit ratings have been downgraded than upgraded since the start of the current business expansion in 1982 (Table 2). Today, the universe of AAA-rated industrial and utility corporations has been cut

TABLE 2
Changes in credit ratings of nonfinancial corporate and state and local government bonds
Number of upgradings (+) less downgradings (−)

	Nonfinancial Corporate Including International[1]	State and Local Government[2]
First Half 1986	−97	+47
First Half 1985	−135	−66
1984	+1	−116
1983	−98	−157
1982	−154	−127
1981	−31	−81
1980	+13	−9
1979	+28	−95
1978	+22	+158

[1] Standard & Poor's
[2] Moody's

to 26 from 56 a decade ago, when the economy was smaller. Currently, the size of the high-yield bond market (with credit ratings below BBB) is about $100 billion, or roughly 21 percent of outstanding corporate bonds. In 1976, the size of this market was nearly $19 billion, or 9 percent of outstandings. At present, only the paper of one large bank holding company is rated AAA; ten years ago, there were 14.

A glaring contribution to this erosion in quality has been the simultaneous increase in debt and the actual decline in the equity positions of business corporations. Over the two years 1984 and 1985, the debt of nonfinancial corporations rose by $384 billion, while equity contracted by $99 billion. This contraction comprises the total of retained earnings, which were a positive $53 billion, and net new equity issuance, which was a negative $152 billion. This disturbing pattern, persisting so far in 1986, reflects an audacious leveraging strategy that has gone unchallenged by a smaller or larger degree of economic adversity.

Nevertheless, it is beginning to take its toll. The once smoothly functioning corporate bond market is showing signs of weakness. No longer is it the market leader, a role that has been usurped by U.S. government securities. More importantly, investing in and trading corporate bonds on relative value merits has become increasingly hazardous. "Event risks," such as takeovers, have often resulted in a sudden collapse in credit quality, producing large losses for bond investors. As a result, relative value analysis has been rendered a less useful tool for bond investing.

This credit quality deterioration is also evident in other sectors. In the state and local government market, overall credit quality growth eroded for the seventh consecutive year in 1985, the latest year for which we have complete data. In the agricultural sector, the value of farmland, after peaking in 1981, has fallen by 25 percent, while farm debt has continued to mount. As a result, over the past five years, farmers' net worth has fallen by 30 percent, and many farms are in financial disrepair. Even households do not show the financial strength they enjoyed a decade ago.

Both the ratios of household debt to disposable personal income and to net worth are at record highs—they were 25 percent and 15 percent lower, respectively, ten years ago. In the current business expansion, the consumer's appetite for credit has been voracious. In the past four years, for example, while disposable income has risen by 32 percent, households have taken on 42 percent more in mortgage debt and an extraordinary 73 percent more in installment debt.

In addition to the ongoing deterioration in these sectors of the economy, there is a relatively new area of weakness—commercial real estate construction. We are just beginning to realize the extent of this problem. Significant real estate loan losses have been reported at a number of large banking and thrift institutions, not only in the Southwest, but nationwide, reflecting the fact that rental income is insufficient to support the debt service of many office projects.

An additional facet of the debt problem concerns the data. Now all of us who have worked with debt data should readily concede to the shortcomings of these statistics. The Federal Reserve's flow-of-funds data, a prime source for many of us, have many flaws. For example, information on state and local government borrowing is provided with a long lag by the Census Bureau. The U.S. Treasury, for cost-cutting reasons, has moved to voluntary reporting on many of the capital flows between residents of the United States and foreigners. The data on borrowing and investing abroad by domestic corporations are inadequate in terms of accuracy, completeness, and timeliness. The statistics on corporate pension funds and public retirement funds are incomplete and, like many other data, are available only with a considerable delay.

Nevertheless, imperfections in the data do not invalidate the conclusion that the nation faces a very serious debt problem. If anything, the available data probably understate the magnitude of the problem. For example, the Federal Reserve's flow-of-funds data tend to be revised sharply upward from the preliminary report. As shown in Table 3, two years after the release of the preliminary fourth-quarter 1983 flow-of-funds statistics, the upward revision for nonfinancial debt was nearly 7 percent. It ranged as high as 40 percent for some subsectors.

In addition, we should all understand that the enormity of the debt situation is being masked by accounting conventions and liberal official regulatory standards. Financial statements often tend to show a netting out of assets and liabilities. Given current balance sheet conventions, many business and financial entities probably employ greater leverage of debt to capital than is readily discernible.

The underlying causes of debt growth

How did this enormous growth of debt come about and what is sustaining it? Merely to blame the incorrect policies that fueled inflation is too easy. There is much more to the debt explosion. I have written at length about the underlying causes of the surge in debt. For this discussion, let me summarize with the following seven points: the attitude toward debt, financial deregulation, financial innovation, securitization, financial internationalization, the tax structure, and practicing debt prudence.

The attitude toward debt has been a transformation from a hesitancy to borrow in the early

TABLE 3
Revisions in fourth quarter 1983 flow-of-funds
(Billions of dollars)

	1983:4Q	Revisions 1984:2Q		1984:4Q		1985:4Q	
Category	Billions	Billions	Percent Change	Billions	Percent Change	Billions	Percent Change
Total nonfinancial debt	509.5	526.4	3.3	526.4	3.3	542.9	6.6
Government	186.6	186.6	0.0	186.6	0.0	186.6	0.0
Tax exempt	44.3	56.3	27.1	56.3	27.1	57.3	29.3
Corporate and foreign bonds	15.0	15.7	4.7	15.7	4.7	16.0	6.7
Mortgages	168.6	167.3	−0.8	167.3	−0.8	180.3	6.9
Business loans	19.1	27.3	42.9	27.3	42.9	26.8	40.3
Consumer credit	54.2	51.3	−5.4	51.3	−5.4	56.7	4.6
Open-Market paper	−1.2	−1.2	0.0	−1.2	0.0	−1.6	33.3
Other	23.0	23.1	0.4	23.1	0.4	20.7	10.0

post World War II period to an intense use of credit in recent years. This attitudinal change reflects the declining influence of those who experienced the Great Depression of the 1930s. Indeed, despite a series of greater or less serious financial crises during the past 20 years, only relatively few institutions failed. Today, no one celebrates paying off the home mortgage. Now, corporate financing strategies do not differentiate between money and credit or between liabilities and liquidity.

Financial deregulation, regardless of its merits, still facilitates the creation of debt, because it spurs competition, and reinforces the drive for new markets and enlarged market standing. Credit growth was more inhibited when markets were more compartmentalized and institutions were more restricted in their activities.

Financial innovation, by its very nature, either facilitates a credit that could not have been financed at all using earlier techniques or is utilized to reduce financing costs. Perhaps the most far-reaching of the many changes that have been introduced in the past few decades has been floating-rate financing. This technique enables financial institutions to try to insulate themselves from the interest rate risk by quickly passing on increases in the cost of their sources of funds to their borrowers. In the past, a move toward higher interest rates curbed debt growth because financial institutions could not easily pass on the higher costs to their customers. But with the advent of the pass-through device of the floating-rate note, financial institutions have become aggressively more entrepreneurial and growth oriented than in the past.

Securitization, which transforms obligations from nonmarketable to marketable, has encouraged debt growth in several ways. First, it tends to create the illusion that credit risk can be reduced if the credit instruments become marketable. Holders of the marketable obligation frequently believe that they have the foresight to sell before the decrease in creditworthiness is perceived by the market. Second, the enhancement techniques employed in securitization, such as credit guarantees and insurance, blur the credit risk and raise the vexing question, "Who is the real guardian of credit?"

Internationalization of finance has also enhanced debt creation. Today, major corporations and official and private institutions seek the best terms by borrowing in Europe, the United States, and Japan. Rapid advances in communications and technology, together with financial deregulation abroad, have intensified competition among key financial centers. In view of the differences in the degrees of deregulation, regulatory requirements, and accounting standards, the opportunity to generate debt is very great indeed.

Our tax structure is another factor that encourages the use of debt over equity. Interest payments are generally tax deductible. Although this preferential treatment may be curtailed somewhat by the proposed tax reform, dividend payments are still subject to double taxation and the levy on capital gains may be raised.

Practicing financial prudence is virtually impossible for major participants in our financial system. Even the best compromise. For business corporations, this may happen through the use of greater leveraging to avoid a takeover. As I have noted in my book, "If (financial) participants fail to adapt to the new world of securitized debt, proxy debt instruments, and floating-rate financing, then they lose market share, make only limited profits and do not attract the most skilled people. The driving force behind profit generation is credit growth."[1]

The risks and policy challenges of financial stability

What risks do the mounting debt pose for financial stability? Here no simple formula will reveal to us the flashpoints of economic and financial trouble. The fact is that the debt buildup in the past two decades has been greater than most would have thought tolerable. Several credit crises have been surmounted, and both the economy and financial markets have survived. Interest rates rose to levels that were unimaginable in earlier years. But while the financial system remained intact, its structure and financial practices were altered dramatically. Nevertheless, it cannot be denied that our system is now more marginal and more highly leveraged than at any time in the past 40 years. This might be less disturbing if business cycle volatility had been sharply curtailed, but this has not been the case. Another matter of concern is that debt can severely restrict freedom of action when income slows and debt servicing needs preempt much of the income that is left. In contrast, of course, large equity positions relative to debt provide society with enhanced freedom and maximum economic flexibility. Given these observations, huge debt will add a very troubling dimension to the next business recession. If a major economic and financial upheaval is to be avoided, official policymakers must act with alacrity. There will be less leeway for errors in policy decisions and implementation.

The greatest need is to harness effectively the growth of debt. How can this be accomplished in our new financial world of deregulation, securitization, globalization, and innovation? We cannot and should not attempt to return to the financial markets of yesteryear. Too much has changed. We need a framework that will get the best out of the current financial system and ward off the worst. The resolution to the debt problem has at least two dimensions. One is immediate. How do we defuse the debt explosion without risking a major economic calamity? The other is

[1] Henry Kaufman "Interest Rates, the Markets, and the New Financial World," Time Books, New York, 1986.

closely related. It involves the kind of disciplines and practices that should be implemented to foster reasonable, but not excessive, debt growth.

Unfortunately, history offers little encouragement in this regard. In the period before World War II, excessive debt was generally eliminated through bankruptcies and failures that, if large enough, brought about precipitous economic contractions. Today, this form of discipline has become unacceptable, although during each economic contraction in the postwar years, debt growth slowed but did not shrink. Actually, we are moving in a new direction in this new financial world of ours in which aggressive financial practices are proliferating. An official safety net is being spread under many financial activities. No longer are market forces allowed to exercise their full discipline over large financial institutions. Depositors of smaller institutions enjoy the protection of that safety net. It is also my belief that obligations covered by credit insurance and by the implied guarantee of the federal government—as is the case with many credit agencies—benefit from an implied official safety net.

With this in mind, how do we steer the economy toward moderate debt growth and at the same time avoid deflation? The magnitude of the debt problem itself suggests that it would seriously undermine the ability of the economy to revive quickly from the next business recession. Consequently, until there is solid evidence of a significant economic rebound, monetary policy must take the risk and err even further on the side of accommodation. Lower interest rates will ease the debt burden in the United States and, particularly, in the developing countries. Further monetary ease will give many marginal borrowers the opportunity to survive. We must stretch out the period in which debts can be written off by creditors and in which debtors, therefore, can recoup earning power. To be sure, this monetary policy approach runs the risk of rekindling inflation, but the alternative is also punishing. Deflation is the more immediate threat to our economic and financial stability. On the one hand, the monetary throttle can always be pulled back if need be, but on the other hand, once a deflation is under way, even large reserve injections may not immediately halt the decline in economic activity and the contraction in income flows.

Monetary policymakers today face the dilemma that the new financial world has rendered obsolete the once simple rules for conducting policy. In this new setting, the Federal Reserve is encumbered by a poorly defined monetary approach; therefore, it must be more highly judgmental than in the past. The Federal Reserve must have insights into the rapidly changing financial developments and their policy implications. Even if these insights are timely, they may not be sufficient in formulating an effective policy because many of the new financial practices are beyond the immediate control of the Federal Reserve.

In addition to the immediate monetary policy quandary in dealing with the debt explosion, there is the serious question of appropriate fiscal policy. Since the U.S. government has accelerated the rate of its borrowings more than any other sector, it would seem at first blush that a sharp reduction in the budget deficit would seem appropriate. Here, we face a serious judgment problem in policy, because a drastic pullback in the deficit would contribute to fiscal drag just when the economic growth is seriously lacking in vigor. This, in turn, will add to the Federal Reserve's difficulty in deciding how much more accommodating monetary policy should be to offset the fiscal drag. Some studies have claimed that fiscal policy initially can have a more powerful influence than monetary policy. A study by the Organization for Economic Cooperation and Development, for example, reveals that a two-percentage-point cut in short-term interest rates raises real GNP growth in the United States by ½ percent over three years, while a rise in government spending by 1 percent of gross domestic product (GDP) increases the level of real GDP by 2½ percent during this period. While this example may overstate the problem, if there is a fiscal pullback, then the pressure is on monetary policy to be very accommodating.

The fiscal quandary and its implications for debt growth and economic and financial stability are deeper still. A huge reduction in the deficit over a short time span weakens economic activity even further, while small reductions would do little to solve the "deficit problem." If another recession should take place with a large deficit at the outset, it will be extremely difficult for our legislators to opt quickly for an even higher deficit. Thus, the legacy of the debt explosion that we have experienced may well be that the next recession will have to be overcome mainly through monetary ease with little help from fiscal policy. The University of St. Louis economist Hyman Minsky has often pointed out that fiscal and monetary stimulus has rescued the financial system from the crises since World War II. The question for the future is, "Can monetary policy do it alone the next time around?"

Some specific recommendations

Much of the feared reflation that might result from substantial monetary stimulation over the near term would most likely be contained if we initiate structures and disciplines that are rooted in the realities of the new financial world. Procedures and a governing process should be set up that fully recognize that markets and institutions are no longer neatly compartmentalized. I continue to believe that the following suggestions, if adopted, would go a long way toward stabilizing the debt situation.

(1) Many of the current regulatory bodies should be eliminated. In our rapidly changing financial system, in which institutions perform a multiplicity of services, is it efficient to have so many regulators on both the state and federal levels? These regulators are largely vestiges of our past financial development. At times, they compete with each other and they do not have an integrated view of today's financial world.

(2) Centralized monitoring and regulation of our financial system should be established. I continue to urge, as I did in congressional testimony more than a year ago, that the prudential responsibilities of the Federal Reserve should be enlarged to encompass institutions other than banks, or that a National Board of Overseers should be established to monitor and promulgate codes of minimum behavior for all major financial institutions.

(3) Financial institutions should be required to report their assets at the lower of cost or market value. Losses would then be quickly recorded, inducing managements of financial institutions to turn toward more conservative practices.

(4) There should be much greater disclosure by financial market participants—including institutions and corporations—in their financial statements. Assets and liabilities should not be netted out. Contingent liabilities should be reported in detail, thus providing creditors with the opportunity to improve their ability to access the credit standing of debtors.

(5) If this type of disclosure continues to be inadequate, then the official regulatory agencies should be required to rate the creditworthiness of the financial institutions under their jurisdiction. These ratings should be made public after a delay, thereby allowing the institutions time to remedy any problems before the public is apprised.

(6) We should adopt tax policies that foster the enlargement of equity capital, rather than the excessive use of debt. In this regard, the double taxation of dividends and the capital gains tax on equity shares should be eliminated.

(7) The official regulatory agencies should issue regulations that require the gradual enlargement of the capital base of the institutions under their

supervision.

(8) To contain the debt problem, international cooperation and coordination must be strengthened. A new official international organization, consisting of key central bank and other officials, should be established. This organization should work toward achieving uniform accounting, capital, and reporting standards of major financial institutions. It should monitor international capital flows more closely by promulgating better reporting standards. In a world with a rapidly growing web of financial linkages, such improvements are essential not only to rein in debt growth, but also to achieve effective monetary policies.

These recommendations are designed not so that we return to the structural world of finance of a few decades ago, but rather to remedy the problems that have been created in this new environment. If failures and bankruptcies are unacceptable, then institutions and markets must be required to adhere to standards that prevent many of them from moving to the brink of failure. A strong financial system should encourage equity instead of debt and should insist on understated asset values, rather than liberal accounting standards and hidden liabilities. The changes that need to be made to prevent a debt crisis from causing major damage are difficult to engineer, because the many vested interests involved will attempt to limit the necessary legislative initiatives. The urgent need is far-reaching decisions now—not when the debt problem has completely overwhelmed us.