

Commentary on "Increasing Indebtedness and Financial Stability in the United States"

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Benjamin Friedman's paper considers some recently popular questions among regulators and some parts of the financial community. When measured against some appropriate benchmark, is the aggregate debt in the United States rising too fast? Does the recent growth of debt pose a problem for monetary policy? What could, or should, be done?

Friedman concludes that there are some problems or, at least, some reasons for concern particularly in the corporate sector. Corporations are more highly leveraged and, therefore, he believes there is increased risk of default. Households have more assets as well as more debt, but he suggests, the debt has longer duration than the assets, so there is increased risk of default or debt restructuring for households also. Since defaults are **procyclical**, **Friedman** is concerned that the Federal Reserve may have to be more cautious. They may be required to avoid the sudden shifts in policy for which they are famous, or perhaps infamous. And policy may be more inflationary both to avoid recessions and to reduce the real value of outstanding debt. **Friedman** does not consider that inflationary policy might encourage what it did seek to discourage. Neither does he consider the benefits of failure and default.

Some general comments

Before turning to some of the data that **Friedman** has brought together, I want to make three general comments about the problem. First, I believe that interest in this issue has been heightened because of some largely incorrect and unfounded remarks by Federal Reserve Chairman Paul Volcker, Federal Reserve Bank of New York **Presi-**

dent E. Gerald Corrigan, and some members of Congress. Second, I believe the risk to financial stability posed by the problem **Friedman** discusses is small relative to the problem posed by the international debt of some less developed countries or the problems of the Federal Savings and Loan Insurance Corporation and its clients, or the recent effort to depreciate the dollar. Third, I find little information in debt-to-income measures or debt-to-asset measures of the kind **Friedman** uses. I develop each of these points briefly.

Chairman Volcker and President Corrigan made the mistake of comparing new issues of debt to retirements of equity, the latter resulting from leveraged buyouts, mergers, acquisitions and, most of all, from the increased use of credit markets in place of banking markets. Their error was to neglect the increase in the market value of the assets acquired by issuing debt. **Friedman's** data **are** as free of this error as currently available data can make them. From his Table 5, we can compute the debt-to-net worth and debt-to-asset ratios for the years available. These data show that the debt-to-net worth ratio at the end of 1985 is lower than the comparable ratio in 1970 and not much higher than in 1965. The debt-to-asset ratio for 1985 is below the 1965 and 1970 ratios. The data are shown in Table 1. My conclusion is that **Friedman's** data show no evidence that corporate debt levels are high relative to available measures of corporate assets. The contrary view is based on the choice of 1980 as the base for comparison. This is an inappropriate choice since 1980 is near the end of a period of high inflation. Parenthetically, I may note that the Federal Reserve's recent policy of restricting debt issues and leverage finds no support in the data.

TABLE 1
Debt Ratios, 1960-85

	<u>1960</u>	<u>1965</u>	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>
Debt/net worth (in percent)	54.8	66.0	70.7	53.7	53.1	67.3
Debt/total assets (in percent)	35.4	40.8	41.3	34.8	34.7	40.2

Source: Benjamin Friedman's Table 5

The Federal Reserve and the government encourage banks to increase lending to less developed countries, especially to countries with recent debt servicing problems. At the end of 1985, all developing countries owed about \$850 to \$875 billion, and their debt was rising at a rate of 4 to 5 percent per year.¹ United States banks owned nearly 25 percent of this debt and 20 percent of the \$500 billion debt of countries with recent rescheduling problems. Last winter, I calculated that for a country like Mexico to be able to return to the financial market by 1990 without special assistance, exports would have to grow at a compound rate of 11 percent per annum. This is considerably faster growth than Mexico has achieved for any sustained period. These calculations were made when the market predicted that oil prices would fall by \$4, not \$14, this year. Compared with the possible losses on Mexico debt—not to dwell on Nigeria or Peru or the farm debt or the thrift associations—the problem Friedman addresses is low on my worry list;'

Debt ratios are ambiguous. A high or rising ratio of aggregate debt to aggregate income or of business debt to business income may be the sign of either profligacy or perceived opportunity. The country may be on a spending spree, marked by high consumption and riotous living. Or, it may experience a surge of investment to take advantage of returns that, to the borrowers, appear well in excess of the cost of borrowing. Even national governments may borrow to finance productive investments in infrastructure or in capital, although this is not the common pattern in the United States. What matters for countries, as for firms and households, is the use of resources whose accumulation is financed by debt. When we turn to the data on allocation, we get a different perspective. These data show that currently the share of gross national product (GNP) used for nonresidential investment and personal consumption are near the highest values reached in the years 1951-86. For consumption, the peak is 65.6 in 1983, and the preliminary value for the first half of 1986 is 65.2. The range is small, however; the lowest value is 61.6 in 1974. For nonresidential investment, the 35-year range is 9.0 to 12.1 percent. For the first half of 1986, the preliminary data show that the United States continues to invest in productive assets at a rate that is above

¹ Data in this paragraph are from A. H. Meltzer, "International Debt Problems," *Contemporary Policy Issues*, forthcoming.

the average for the postwar period. Investment is not rising rapidly, but neither is **GNP**. The investment share remains **moderately** high.

A more serious problem

A more serious problem, in my view, is that when we add up all the spending shares, their sum is more than 100 percent. The reason is that U.S. spending exceeds production by almost 2.5 percent. We run a net export deficit and borrow from the rest of the world to maintain our spending. Each addition to our foreign borrowing carries an obligation to pay interest, so the longer we delay closing the gap between production and spending, the more we will owe foreigners and the larger the amount by which our future production must exceed our future spending. Eventually, we will have to close not just the deficit in net exports but the current account deficit. Our net interest payment to foreigners are part of that deficit, and they are rising at a rapid rate.

Unless our investments in nonresidential capital are extremely productive, we face a sizeable decline in living standards. This may be brought about by further depreciation of the currency, by restricting imports, by extending government sponsored cartels from steel, autos, textiles, microchips and food to additional products, by taxing ourselves to subsidize exports, or most likely by some combination of these policies. The temptation to inflate away some of the debt accumulated by those foreigners who persist in selling us better quality products at lower prices seems to me much more of a threat to future stability than the problem **Friedman** discusses. The Federal Reserve and the Treasury seem eager to depreciate the currency and to inflate, not to reduce corporate debt but to reduce real consumption and the dollar-denominated debt held abroad.

While I am cataloguing prospective problems, let me add the risks that trade frictions and protection pose to the system of political and military alliances that have maintained a considerable degree of international stability in the postwar years. Can these alliances be expected to retain their present structure if there is a substantial decline in the relative and absolute wealth and income position of the United States? Can they survive the reduction in trade that may follow protection and retaliation? I do not know the answers, and I doubt that they are known. I mention them to indicate that, if one is inclined to worry about debt, there are more worrisome problems than those discussed in the paper.

A possible benefit

One of Friedman's concerns is that higher risk of private default may make the Federal Reserve less willing to risk a recession than in the past. He suggests that this may lead to higher future inflation. I share his concern that inflation will return, but I do not accept his argument. His conclusion does not follow.

Japanese firms have much higher debt-to-output ratios than U.S. firms, and the same is true of large German corporations. Yet both countries have lower average rates of inflation, and Japan has substantially less variability of output. Japan is the only major country that did not have a recession during the 1980s. In fact, Japan's growth rate of real output remained between 3 percent and 5 percent annually for nearly a decade. Yet Japan was able to reduce measured inflation from 20 percent to approximately zero during this period.

Japan's corporations have debt-to-sales ratios of about 100 percent. Public debt is now 42 percent of GNP? Goldsmith (1983) shows that the ratio of loans and debts to GNP rose throughout the postwar years, from 0.9 in 1955 to 1.9 in 1977. These numbers are as large, or larger, than comparable data for the United States, and I believe Japan's debt-to-GNP ratio has increased since Goldsmith wrote.

The **Bank** of Japan announces monetary objectives and comes close to achieving them. If larger debt ratios induce the Federal Reserve to do the same, we should welcome them. A more disciplined approach to policy—monetary and fiscal—with closer correspondence between promise and performance and fewer surprises would be a welcome improvement.

Why more debt?

Friedman does not give any reason for the rise in the debt ratios. I would like to close by suggesting three—taxes, anticipated inflation, and for households, changing age composition?

Miller (1977) showed that high corporate **tax** rates encourage the use of debt as a means of reducing the cost of capital. This use of

² The data are from (1) The 116th **Tankan**, Short-Term Economic Survey of Japan, Research and Statistics Department, **Bank** of Japan, (2) Japan 1985, **Keizai Koho** Center, Tokyo, and (3) Goldsmith (1983, p. 216).

³ Friedman suggests that inflation may come, but he does not suggest that **borrowing** is done in anticipation of inflation.

debt is in the interest of stockholders and should be welcome. The proper policy response, if debt is to be controlled, would seem to be elimination, or substantial further reduction, in the corporate tax rate to reduce the gains from leverage.

Anticipated inflation is an obvious reason for going into debt. Was it an accident that corporations increased debt relative to GNP and to their net worth in the late 1960s, when inflation was low? Or, did the stockholders benefit from farsighted managers' decisions to bet against continued low inflation? Are managers placing their bets now on higher inflation? The fact that debt ratios were low in 1980, the base **Friedman** uses for many of his computations, probably reflects, in considerable measure, the previous inflation.

For households, age composition plays a role. Life cycle theory implies that households accumulate debt in early years, save from the middle years to retirement, then dissave. As an approximate life-cycle measure, I computed the ratio of dissavers to savers by taking population aged 20 to 24 and aged 65 and over as net dissavers and the population 45 to 64 as net savers. Table 2 compares liabilities to net worth, computed from **Friedman's** Table 3, to the ratio of dissavers to savers. Tax rates and anticipated inflation should affect the relation. These effects are ignored. Nevertheless, for the 25 years shown in the table, the debt to equity (liabilities-to-net worth) ratio rose by 48 percent. The ratio of dissavers to savers rose by 44 percent. The comparison suggests that the household ratio may reflect life-cycle considerations that will continue as the population ages and the proportion of dissavers rise.

TABLE 2
Household Debt Ratio and Proportion of Dissavers

	<u>1960</u>	<u>1965</u>	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>
Household liabilities net worth (in percent)	13.1	15.4	15.8	16.8	16.8	19.3
Dissavers/savers (in percent)	76.8	82.7	88.8	96.4	106.4	110.7

Source: Benjamin Friedman's Table 3

In sum, I **think** there are many more serious problems than the problems addressed in the paper and, I suspect, **Friedman** may agree with this. The best way to avoid problems of excessive leverage in the future is to allow market discipline to work. It should not be surprising that **borrowers** and lenders accept more leverage when government prevents failures at **Lockheed**, Chrysler, the Continental Illinois holding company and a long list of others. And the best way to control inflation is not by worrying about leverage and debt but by adhering to stable, noninflationary money growth.

References

- Goldsmith, R., *The Financial Development of Japan, 1868-1977*. Yale University Press, New Haven, 1983.
- Miller, M., "Debt and Taxes" *Journal of Finance*, 32, May 1977.