Overview

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I will be commenting mainly from the viewpoint of macro policy, which just about makes me the third commentator on the last panel. But I will also attempt to bring in some of the other aspects of the debt problem that have been discussed here in these two days.

Debt, and its relationship to other economic variables, such as income, is not a concept that can be easily employed to provide direction for macro-economic policy. I do not think of debt as, for instance, a policy handle like one might think of the money supply, although it less serves that function these days—or as one might think, on the fiscal side, of the high employment budget deficit or surplus. Rather, I tend to think of debt more as one among the many economic variables you assess for the insight it gives into current economic and financial circumstances and processes. You look at its trends, cyclical behavior, and current tendencies to help in analyzing the economy and in deciding on how whatever policy instrument you have at hand is to be used. Debt is only one aspect of the economy among many; I doubt that it has a unique status as might be confirmed by stable or highly predictable historical relationships to GNP or other key variables.

With regard to the value of debt as a policy tool, I should add that when Ben Friedman was first doing all of his work on the subject, it had some implications, of course, for work within the staff of the Federal Reserve. I do not mean merely that Ben took up a considerable amount of the time of our Flow of Funds Unit in providing data that he needed. We also attempted some of our own research in that area. As I remember it, the results of one analytic approach showed that debt was much more a coincident than a leading indicator in relation to the economic cycle—in contrast to measures of money, most of which showed more of a leading than coincident role. So that fortified my view that debt should be viewed basically as one analytic device among others rather than as a policy handle or a unique policy variable.

If changes in debt are coincident with changes in gross national product (GNP), one might argue that if you could control debt, you could control GNP. However, there is no practical way to control debt as a whole directly in our economy. Control would have to be indirect through, say, interest rate policy, which basically influences debt through effects on spending. So in the end you are talking about how to control GNP, not debt as such, and therefore, raising all the basic problems in that regard, which have been the subject of economic discussion from time almost immemorial.

In any event, I should quickly say that debt developments have effects that policy cannot ignore. Not all these effects stem from the inadequate macro-economic policies of the past that might have encouraged excessive borrowing or lending or from policy measures taken later to rectify those problems. Rather, some debt problems stem from underlying structural changes that are imbedded in economic expansion, developments in financial technology, and adaptations to a changing competitive environment in the national and world economies.

The international debt problem strikes me as one that comes in large part from the inadequate macro policies pursued in the developing and developed countries in the 1970s—policies that, on the one hand, encouraged countries, particularly the less developed countries, to mortgage their futures on the thought that debt burden would forever be light in real terms and, on the other hand, encouraged banks in the developed countries to get into a "go go" attitude on the thought that prices and markets would expand forever. But there were also structural elements. Large institutions, goaded by expanding international competition in banking and fighting for market shares, engaged in risky lending policies. This engagement led to a degree of cooperation among central banks and banking supervisory authorities in the major countries, but in my view, cooperation was late in starting and difficult to achieve.

In the United States, the banking system also had a difficult time in adjusting to structural changes implicit in deregulation of interest rate ceilings. The deregulation was clearly necessitated by the rise in interest rates generated out of the inflation of the 1970s, but deregulation was something that should have been done in any event on economic efficiency grounds. After years of suppressed, controlled deposit rates but free lending rates, there was, I believe, "surplus" profits in the banking system, although evidence is probably unclear on this point. To the extent there were surplus profits, you would have to expect those profits to be competed out as deposit ceilings were lifted. One consequence would be a significant decline in the number of banks.

That decline is being accomplished through mergers and acquisitions. The problem is that we are having a hard time finding good large banks to buy the smaller weak banks, and we are having a worse time finding good large banks to buy the weak large banks. In effect, an orderly decline in number occasioned by deregulation is being compounded in difficulty by the layering on top of it of the need to merge banks that are in danger because of loans made during the inflationary period and the period of "go-go" banking.

Debt problems in the energy and agriculture area as they affect both lending institutions and borrowers are also to a great extent structural. In the energy area, problems have evolved out of the conservation that developed from the earlier oil price hikes that subsequently helped keep oil prices and production down. In agriculture, we have had something of a revolution in production, which probably was not properly assessed by the agricultural producers and the agricultural lenders—although the speculative, inflationary environment of the 1970s also was clearly a main force behind overexpansion of farm lending.

Partly for structural reasons, debt problems and some areas of financial weakness are going to endure for some time, though I believe they will continue to be reasonably well contained without significant adverse systemic effects. Such problems are also going to be intensified in the degree that we continue to need to maintain relatively high real interest rates to combat pressures of inflation and inflationary expectations. As those pressures ease off, nominal and also real interest rates can and should come down, easing debt and financial problems to a degree.

I would take the rise in the debt-to-GNP ratio over the last few years in a way as evidence of the persistence of inflationary pressures. Summers has shown by fitting a trend line—though starting, as Ben has pointed out, in a dubious place—that private debt has expanded about as expected while government debt expansion has had its ups and downs, mainly ups in recent years, of course. Yet the U.S. fiscal stimulus has had large disadvantages in that it has squeezed out, on Summers' estimate, domestic investment and to a degree internationally-oriented industries—though I am sure we all agree, and he agrees, that these estimates understate the extent to which internationally-oriented industries have been squeezed out.

But if at least some domestic investment has been squeezed out in recent years, how do you account for the increase in private debt at about a little more than trend? Perhaps it is all rapid expansion in consumer debt. But an obvious possibility is that once the economic situation began to improve toward the end of 1982, private debt, to anthropomorphise the concept a little, really wanted to go up by more than trend to make up for earlier depressed spending. It was held back from rising more than trend, one might then assert, by the high real interest rates that prevailed on average over the 1983-85 period.

Without these high rates and the accompanying high exchange rates, inflation and spending financed by private debt would have been even greater because, I take it, inflationary expectations had lingered on at relatively high levels, probably much higher than it looks to us now in retrospect when we see 3 to 4 percent price increases for several years. It took that experience to bring inflation expectations down.

In that context, I would not play down the expansion of the federal debt as a macro policy problem, as Summers seems to, on grounds that monetary policy could in any event maintain growth in the nation's income or because federal debt does not adversely affect market behavior since, in practice, it is free of default risk. Rather, the sharp expansion in the overall debt ratio propelled, it is right to say, by the federal government debt can, in my view, be taken as one sign of the remaining inflationary pressures in the economy, with the actual rate of inflation held down in part by the appreciation of the dollar over the period. The federal debt expansion might be viewed, at least to a degree, as a "proxy" for the private debt that wanted to surge but could not because of the high real interest rates of the period. Such rates were the product of the growing budget deficits and also of the need for a degree of monetary restraint to contain the inflationary pressures that would have otherwise developed.

On a related tack, I would also want to argue that rapidly growing federal debt, particularly in that period when private debt is also expanding rapidly, interacts with monetary policy through its effect on inflationary expections. While the public does not bother itself with economists' stability conditions, they still realize, I believe, that rapidly expanding federal debt cannot go on forever without overburdening the tax system. Something will happen. Perhaps the public will believe that there is no risk of formal default. But they see such things as changes in law that adversely affect cost of living provisions for retirees. Because it seems like a breach of "contract" by the government, that sort of occurrence, I believe, takes the edge off of confidence in the federal debt. This type of attitude is also illustrated in doubts about the viability of the social security system, irrational as we may think such doubts to be.

The ostensibly more sophisticated people may tend to think the government will reduce its debt burden in another way—through inflation, which, to my mind, is a form of default. It is not a formal default, but it reduces the real value of the debt. Thus, a rapid expansion in debt relative to GNP is very likely to keep inflationary expectations higher than otherwise, forcing the monetary authorities to deal with a worse unemployment-inflation trade-off.

As a result, whether the authorities have a price objective or an objective expressed as growth in nominal income, real income is going to be affected adversely if inflationary expectations are stronger than otherwise. This effect on real income will alter the nature of the macro policy decision. It will require reassessment of what near-term economic objectives should be, of how the objectives might be attained, the time path over which lower price increases may be sought, and the extent to which economic weakness need, or should, be risked. These choices are much less difficult when inflationary expectations are low.

Ben Friedman suggests that as debt rises relative to income and as debt problems from international and domestic sources permeate the depository system, an inflationary bias may be imparted to monetary policy. If there were to be such a bias, that would be a good reason to keep debt problems under control in the first place. But more pertinently, the debt problems are mainly the result of the inflationary bias of monetary policy in the 1970s; they were not the cause of such a bias. Policy had an inflationary bias before the debt problems became evident for reasons that would probably take a shrewd sociologist to understand as well as a psychologist specializing in economists' drives toward wrong economic projections. And if monetary policy attempts to deal with debt problems and financial difficulties by creating a bit more inflation and lowering real interest rates at least temporarily, we will in the end run the risk of having to deal with another financial problem—unless banks, other lenders, and the political powers of nations in this highly competitive and integrated world show more self-restraint than experience to date would seem to suggest.

Financial difficulties could have been alleviated to a degree by a different macro policy mix—one with a less expansionary fiscal policy so that real interest rates would have been less high than otherwise. An expansionary fiscal policy was needed to help pull us out of the recession, but I think it went at least a stage and a half of a tax cut too far. Still, the financial problems and instabilities of recent years could not have been entirely avoided, partly because real interest rates also needed to be high over the period to help suppress inflation and inflationary expectations and partly because of the structural changes noted earlier. Thus, the persistence of financial instability can be viewed at least in part as a product of the continued need to combat inflation and also as some evidence of the waning inflationary bias of the authorities.

The policy of curbing inflation has had a considerable degree of success, though obviously more is required before the market becomes convinced that either reasonable price stability or a long-run inflation rate below the area of 3 to 4 percent per year is in prospect. Over the period since late last year, the sharp downward break in oil prices helped reduce inflation expectations and, together with apparent legislative progress in reducing the U.S. budget deficit, set the stage for substantial declines in nominal interest rates and to a degree real rates. Inflation expectations are quite fragile, however—as may be seen from recent upward movements in long-term interest rates in reaction to signs that the oil cartel may succeed in holding prices and to doubts about progress in reducing the budget deficit.

Policymakers at the Federal Reserve have a most difficult judgment to make with respect to inflation expectations. If they have been reduced sufficiently, the pressure can and should be taken off market interest rates, encouraging real rates to decline in the short term. For example, if inflation expectations have been reduced to what is consistent with at least an interim price increase objective, then real interest rates can be lower and the economy encouraged to grow enough to bring unemployment nearer to the natural rate. Whether real interest rates come down because basic inflation expectations (as would prevail at the natural rate of unemployment) have been reduced or because the economy at the present time may be on the weak side, a drop in interest rates should have a beneficial side effect, relieving many of the debt and financial stability problems.

I hope I have said enough to suggest at least that there are many strands to the question of debt and financial stability and that they are by no means entirely independent of macro policies. The threats to our financial stability in recent years have stemmed in good part from previous macro policies and from the policy approaches needed to undo macro errors of the past, not to mention some partly misguided policy mixes in the present. In that process, financial instabilities arise. Some problems, but not all, will be resolved if inflationary expectations can be kept suppressed and lowered and if nominal and also real rates can be kept low or lowered.

In that context, I would stress again that fiscal restraint has a strong role to play in lowering interest rates, and I feel uneasy when people say we should have less fiscal restraint because the economy may look weak. I would argue that we probably need at least what the Gramm-Rudman law promised. That will permit a more stimulative monetary policy and lower nominal and real interest rates stemming from the direct effect of the smaller deficit on markets and the beneficial indirect impact on inflationary expectations.

I do not want to leave you with the idea that financial instabilities do not also arise independently of macro policies. They do, and from the perspective I would like to add my bit of support to comments by Henry Kaufman and Peter Cooke—Peter having the more realistic, and Henry having the more idealistic, view of what can be done in the area of international cooperation in regulatory and supervisory policies. Peter's view is undoubtedly right. I would hope, though, that a little more could be done—that efforts could be carried beyond banking issues, where some little progress has been made by the major countries meeting at the Bank for International Settlements, and extended to other financial institutions and markets as well.

In that respect, it is clear to me that central bankers ought to take the lead because it is their policies that are the most at risk from market instabilities and it is their discount windows that are needed to protect economies and markets from liquidity crises. At this point, it might be desirable to evaluate problems that may be associated with central bank lending to relieve liquidity pressures, even though such lending works in a sense to resolve problems. Such an evaluation may help in understanding why it is important for central bankers to become intimately involved in keeping a financial system generally stable.

When I was at the Federal Reserve, I spent some time trying to assess, as a contingency planning exercise, what would happen if there were huge demands on the discount window from failing or illiquid institutions. I had in mind Bagehot's view that it is the duty of a central bank in a liquidity crisis to lend and lend and lend again. Starting from that premise, it was not difficult to conceive that borrowing at Federal Reserve banks would reach on the order of $30 billion. In recent years, for instance, Continental Illinois Bank alone borrowed some $5 to $6 billion.

One of the first questions raised by so large an expansion in central bank lending and bank reserves is its inflationary potential. Clearly, such expansion has very little, if any, such potential in the short run, given the circumstances of the bank reserve growth. And over time, you could entirely offset the expansionary effect on bank reserves and money through open market sales of securities. But in the short run, it would not seem advisable to offset all the expansionary effect. Because the borrowing reflects liquidity problems, it would appear desirable to let the money supply rise more than otherwise, at least temporarily, to accommodate to greater demands for liquidity in the economy.

Reaching such a conclusion did not seem very hard. The hard part was assessing the likely reactions of market participants. My judgment was, and is, that their responses would be adverse to the economy. Others here have mentioned that, under the circumstances, those who withdraw funds from institutions in difficulty would put their money somewhere else. So no funds are "lost." True enough, but that overlooks price effects in the process. In particular, money can easily go abroad, not only foreign funds invested here but also U.S. funds. That is not lost money, but it would have significant effects on the dollar exchange rate, which would drop sharply under those circumstances. We have wanted, at times, to see a drop in the dollar, but not one that occurs under near-panic circumstances and reflects loss of confidence in the currency. That will not benefit domestic production, because the producers themselves will also, in my opinion, be participating in the loss of confidence.

When the market perceives borrowing at the Fed is running around $30 billion—realizing it is normally $2 to $3 billion in periods of tight money—doubts about the viability of the whole financial system are likely to become greater. That is very likely to have adverse affects on domestic spending. All of this is difficult to prove, and certainly the situation would be much better with a central bank able to lend than if there were no lender of last resort. Still, I suspect there would be a dropoff in consumer and business spending—in technical jargon, a downward shift in the IS curve, with, I suspect, the potential for a fairly sharp shift.

That is a very brief and cursory review of some of the broader aspects of this problem. I trust, these conjectures will remain hypothetical and will not be tested in practice. It is obviously an "iffy" area, but that only leads me to believe we would be a lot better off with a financial system that is not prone to large liquidity crises and pervasive instabilities that put the central bank under such pressures. That is one reason—apart from matters of investor safety, protection from fraud, adequate financial disclosure, etc.—for some little (not too much) supervision and regulation, with strong central bank inputs and, in today's world, considerable international cooperation.