Public and Private Debt Accumulation: A Perspective

I welcome this opportunity to address the American Bankers Association annual gathering of Chief Financial Officers. In reflecting on possible topics for my remarks, it struck me that this was a good opportunity to raise some questions about an all too well-known four-letter word. That word is "debt". Specifically, I want to review with you the facts as they pertain to the disturbing rate at which the U.S. economy is accumulating debt; to cite some of the factors which may lie behind the rapid growth in debt; and to make a few suggestions as to ways in which the growth in debt can be—perhaps I should say must be—moderated over time.

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By way of a general background, until recently, the growth in total debt in the economy tended to track closely the growth in nominal GNP. To be sure, there were some departures from this pattern for cyclical and other reasons, but the long run parity between the growth in debt and the growth in GNP was strikingly similar. But, beginning in the 1981-82 time frame something seems to have happened to that relationship. In each of the past several years debt has risen markedly faster than GNP. In fact, using 1981 as a base, the cumulative gap between the growth in debt and the growth in GNP is fifteen percentage points. Stated somewhat differently, over the 1981-85 period, the ratio of debt to GNP will have risen by about 20 basis points to over 1.60—a very large change in a ratio of this nature A straight extrapolation of this recent trend over the next decade would suggest that by 1995 we would have about $2 25 in debt for every dollar of GNP

In a proximate sense, it is widely recognized that the major factor contributing to the rise in total debt in recent years has been the string of massive Federal budget deficits which have been chalked up in the decade of the 80s. While that is certainly true, the rate at which debt is being accumulated in the private sector is also cause for concern. Let me cite a few statistics that seem particularly telling

In the Federal sector, commentary about $200 billion deficits is now so commonplace that we may tend to lose sight of the financial implications of those mega-deficits. For example:

- This year, interest costs of servicing the burgeoning Federal debt will total about $130 billion. That will be roughly equal to total personal income tax collections from every taxpayer west of the Mississippi River At the same time, more than $20 billion of those interest payments will go to foreign holders

Remarks of E Gerald Corrigan, President, Federal Reserve Bank of New York, before the American Bankers Association Chief Financial Officers' Forum on Wednesday, September 18, 1985 of Treasury securities This, in effect, implies that a very sizable percentage of the proceeds of sales of new Treasury securities to foreigners are being used to pay interest to existing foreign holders of Treasury debt

If the current efforts at reducing Federal budget deficits are not successful, then even under fairly optimistic economic conditions, the annual cost of servicing the Federal debt by 1990 will be in the neighborhood of $210 billion...For every five dollars collected from the individual income tax, two dollars will go toward paying Federal net interest liabilities.

- Looking out over the next few years, if the current efforts at reducing Federal budget deficits are not successful, then even under fairly optimistic economic conditions, the annual cost of servicing the Federal debt by 1990 will be in the neighborhood of $210 billion. That will mean that for every five dollars collected from the individual income tax, two dollars will go toward paying Federal net interest liabilities. Moreover, even if near-term deficits were reduced to levels consistent with the targets specified in the recent Budget Resolution, annual net interest payments by the Federal Government would still grow to $180 billion five years from now.

- Federal debt relative to GNP, which had been on a pronounced downward trend over most of the post-war period, is now rising very rapidly. Indeed, for 1985, Federal debt will amount to almost 40 percent of GNP—a rise .of more than twelve percentage points since 1981.

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- An even more alarming picture arises when we look at the deficit relative to our domestic savings flows. In 1984, for example, the deficit consumed two-thirds of our net private domestic savings While international comparisons are flawed, it is nevertheless noteworthy that in Japan, West Germany, and the United Kingdom, budget deficits consumed only 20 to 30 percent of net private savings flows despite the fact that in the cases of West Germany and the United Kingdom, the cyclical component of their deficits was larger than for the United States.

The growth in Federal debt lies at the root of another dramatic development regarding the United States, and that, of course, is the sudden and sizable shift in the position of the United States from a net creditor to the rest of the world to a net debtor The immediate cause of this development is, of course, the unprecedented current account deficits we are running, but as this audience would recognize, the underlying causes for those current account deficits are importantly related to the budget deficit *via* the interest rate, exchange rate nexus Here too, orders of magnitude are so large that they can lose meaning, but the following provides some perspective.

- At this juncture, and short of worldwide economic conditions that would be most distasteful, it is difficult to foresee circumstances in which the foreign debt of the United States would not approach $500 billion by the end of the decade. Indeed, some would suggest that we would have to be quite lucky if that figure were not larger than $500 billion. In considering the possible implications of external debt of this size, there is at least a question as to whether foreigners will be eager to continue to accumulate dollar denominated assets of the amounts suggested at current, much less lower, rates of interest

For the private sector as a whole, the ratio of debt to GNP is at an unprecedented level and is still rising.

- Servicing $500 billion in external debt at roughly current interest rates could produce a $35 to $45 billion gap between our trade and current account deficits and would imply that even approaching current account balance will require not just a balancing of our trade account but moving the trade account into a sizable surplus position

- The "Catch-22" of this situation, however, is that so long as our budget deficits are so large and our domestic savings so meager, we are vitally dependent on those same foreign savings flows which finance the current account deficit to finance our domestic activities including the budget deficit. At present, foreign savings flows are augmenting our net private domestic savings by a factor of more than one-third and are directly or indirectly financing half or more of the budget deficit

In summary, looking at the rate at which we are building debt in the Federal sector and looking at the closely related issue of the rate at which the United States is accumulating external debt, it is difficult to escape the conclusion that we are approaching or in uncharted waters. But, even that's only part of the story since it does not take account of developments regarding debt accumulation in the private sector.

Abstracting from internally generated equity, the 1984-85 period will, if current trends continue, see the *net* retirement of $150 billion of equity in the nonfinancial corporate sector—an amount which in nominal dollars exceeds the net issuance of equity by nonfinancial business over at least the entire post-Korean War period.

To some extent, private sector debt accumulation has been overshadowed by events in the public sector. And, to some extent they have been muted by what, in my judgment, may be a false sense of security growing out of some statistics which, for example, suggest that consumer liquidity is relatively high and rising or that certain debt ratios for nonfinancial business have stopped rising, or are falling slightly. Taking those and other statistical indicators at face value, one could, perhaps, conclude that outside of the Federal Government, all is reasonably well. Perhaps that is so, but I would suggest that a closer look at trends in the private sector may not justify that complacency.

I say that for several reasons including the following

- For the private sector as a whole, the ratio of debt to GNP is at an unprecedented level and is still rising. To be sure, the increase is not as pronounced as for the Federal Government, but there is at least a question as to whether it is reasonable to assume there is that much more good quality debt relative to GNP today than there was a decade or two ago.

- The recent spurt in private sector debt accumulation has, to a large extent, occurred on the upside of the business cycle and the downside of the nominal interest rate cycle and despite what are generally seen as relatively high real interest rates. Since it does not seem at all prudent to assume that the business cycle is a thing of the past, servicing even existing levels of debt in a less favorable economic and interest rate environment could prove very difficult. This is especially true since generalized financial indexation has shifted a sizable fraction of overall interest rate risk from the financial sector to the nonfinancial and household sectors.

- Taking account of where we are in the business cycle, some measures of credit quality problems are disquietingly high. This is especially true, for example, for delinquency rates on home mortgages, and of the overall level of nonperforming loans in the banking system.

- The recent growth in debt has been associated with a very rapid retirement of equity which, in turn, is importantly—but not exclusively—related to leveraged buyouts and the threats of hostile takeovers.

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Given all that has happened regarding patterns of debt accumulation in recent years, it is not easy to capture the underlying reasons for these developments in a few paragraphs. In the case of the Federal sector, I believe that most would now agree that the problem is primarily one of a political nature. Thus, rather than rehashing the familiar elements of that situation, allow me to focus my commentary on the major factors which seem to lie behind developments in the private sector.

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To some extent, recent developments regarding private debt accumulation reflect longer-term trends. Among the longer-term factors, demographics are such that we now have a relatively heavy clustering of the population in age groups that are more prone to borrow. Similarly, a case can be made that a host of technological, institutional, and innovational factors ranging from credit cards to junk bonds are working in the direction of enhancing the accessibility to credit. So too, a case can be made that the worldwide integration of money and capital markets broadens financing options and alternatives for many corporations at any given level of interest rates. These and other factors may be playing a role in the burgeoning rate of debt accumulation but they don't seem capable of fully explaining why the experience of the recent few years looks so different than earlier periods. At the margin at least, it would seem that still other factors must be at work. Let me suggest two or three factors that may help to further explain recent behavior.

- It would appear that at least some borrowers and their lenders are still assuming—consciously or subconsciously—that inflation will bail them out. To the extent that is true, it strikes me as a very bad bet. For one thing, it makes an assumption about monetary policy that, from my perspective. is simply wrong However, it's a bad bet in a more fundamental way because renewed inflation would inevitably bring more instability, not less. Indeed, I don't think it unreasonable to assume that even a sniff of a new outburst of inflation would produce a financial market response in interest rates that could be quite harmful to those with high debt service burdens

Reducing the budget deficit is central not only to establishing a better balance in the utilization of our domestic saving, but it is the only vehicle through which we can achieve an orderly reduction of our dependency on foreign savings while still leaving enough room to finance the domestic investment ultimately needed for economic growth.

- It is possible that very intense competitive forces in the banking and financial sector are such that the pricing of loans and other debt obligations does not fully take account of differences in credit risk, thereby diminishing the rationing effects of the pricing mechanism for debt.

- Financial innovation may be aiding and abetting the debt accumulation process in part by transferring the incidence of credit and interest rate risk in ways that may give rise to the illusion that such risks have been reduced or eliminated.

- Innovational forces have also given rise to certain highly sophisticated financing techniques which are designed to take maximum advantage of certain features of the tax code—a tax code which has strong incentives for debt accumulation in the first instance. Highly leveraged buyouts are the obvious example, but sophisticated tax shelter devices—which by definition spur debt creation—are now readily available even to individual investors with relatively modest income levels A casual reading of the book *Funny Money* which deals with the Penn Square debacle provides a number of amusing but tragic insights into how easily even sophisticated investors can get duped by sure fire "deals" of this nature.

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What's interesting about those episodes in *Funny Money* is that they may be symptomatic of a cultural revolution about debt Homeowners no longer burn the mortgage when it's paid, they quickly get another, and preferably one which, in effect, requires no payment of principal; commercial real estate developers shun even minimal equity investments in new projects; corporate takeover specialists finance their activity by leveraging to the hilt, and in each of these cases somewhere there seems to be a financial institution that will eagerly oblige.

In short, the factors that lie behind the rapid growth in debt in the U S. economy represent a complex interaction of political, economic, technological, market, and attitudinal considerations that will not easily be reversed. Yet, common sense tells us that a continuation of recent trends is not sustainable over the long haul. Looked at in that light, the crucial question, of course, is how can we best go about the process of slowing the rate of debt accumulation in a way that maximizes the prospects for more balanced non-inflationary economic growth in the period ahead. From my perspective, the answer to that question lies in several closely related areas of public policy and private initiative, as follows:

- First, and perhaps most essentially, we simply must do more to reduce the budget deficit in a timely and credible manner The recently enacted budget resolution—if adhered to—is a positive step and provides a margin of breathing room in the near term. But, more needs to be done in a context in which the next steps may be even more difficult to achieve. Reducing the budget deficit is central not only to establishing a better balance in the utilization of our domestic saving, but it is the only vehicle through which we can achieve an orderly reduction of our dependency on foreign savings while still leaving enough room to finance the domestic investment ultimately needed for economic growth. And, only with that need for foreign savings reduced can we bring about the orderly adjustment in our external deficits that is also so essential.

- Second, we should continue to explore ways in which tax policy can be tilted in the direction of greater incentives for savings and equity investment Indeed, the current tax codes—with across-the-board deductibility of interest and the *de facto* double taxation of profits—create powerful motives for debt accumulation by households and businesses alike. To the extent that situation can be altered somewhat in the direction of greater incentives to save and to finance through equity, we will be that much better off Indeed to the extent we can achieve that tilt in a context in which the deficit is also coming down in a decisive way, our prospects for sustained growth will have been enhanced appreciably.

Despite enormous competitive pressure that works in the opposite direction, managers and directors of individual financial institutions will have to more fully recognize that more conservative lending and funding policies are ultimately in their individual and collective interests.

- Third, we must continue to resist the temptation that the solution to our debt accumulation problem lies with accepting a little more inflation. Indeed, and as I noted earlier, more inflation can only bring more instability and greater problems down the road

- Fourth, we must seek out ways to adapt the bank supervisory process to the realities of contemporary banking markets—markets in which many of the traditional sources of restraint have been eliminated by a combination of deregulation and technologically-driven innovation. This effort must entail a general strengthening of the bank supervisory process but also the active exploration of approaches that can move in the direction of encouraging financial institutions to take on more liquid and less risky assets. The latter is one of the reasons why I am strongly attracted to the concept of seeking to take account of risk characteristics in the development and administration of capital adequacy standards for banking institutions.

- Fifth, turning to the private sector, we must see a greater renewal of the precepts of prudence and discipline in the management of banking and financial institutions. Even now there is some evidence to suggest that renewal is beginning to take hold as illustrated, for example, in the number of institutions that are maintaining capital positions well in excess of regulatory minimums. Yet, short-term preoccupation with growth and quarterly earnings performance still seems unbalanced and misplaced More generally, and despite enormous competitive pressure that works in the opposite direction, managers and directors of individual financial institutions will have to more fully recognize that more conservative lending and funding policies are ultimately in their individual and collective interests.

In conclusion, the debt accumulation problem is a matter of concern. Some elements of it will be self-correcting but others will need an assist from public policy and from private initiatives. Those initiatives constitute something of an insurance policy—and a relatively inexpensive one at that—which can significantly raise the probabilities that we can sustain an economic and financial environment conducive to growth without inflation.