Debt dilemma

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I have mentioned many times on this blog that rising global debt reduces the ability of capitalist economies to avoid slumps and find quick way to recover (and see 'Debt Matters' in my book, The Long Depression and also in World in Crisis).

As Marx explained, credit is a necessary component in oiling the wheels of capitalist accumulation, by making it possible for investment in longer and larger projects to be financed when recycled profits are not sufficient; and in more efficiently circulating capital for investment and production. But credit becomes debt and, while it can help expand capital accumulation, if profits do not materialise sufficiently to service that debt (ie pay it back with interest to the lenders), the debt becomes a burden that eats into the profits and ability of capital to expand.

Moreover, two other things happen. In order to meet the obligations of existing debt, weaker companies are forced into borrowing more to cover debt servicing, and so debt spirals upwards. Also, the return over risk on lending for creditors can now appear to be higher than investing in productive capital, especially if the borrower is the government, a much safer debtor. So speculation in financial assets in the form of bonds and other debt instruments increases. But if there is a crisis in production and investment, perhaps partly caused by excessive debt servicing costs, then the ability of capitalist corporations to recover and start a new boom is weakened because of the debt burden.

In the current coronacrisis, the slump is accompanied by high global debt, both public, corporate and household. The Institute of International Finance, a trade body, estimates that global debt, both public and private, topped $255tn at the end of 2019. That is $87tn higher than at the onset of the 2008 crisis and it is undoubtedly going to be very much higher as a result of the pandemic. As Robert Armstrong of the FT put it: *"the pandemic poses especially big economic hazards to companies with highly leveraged balance sheets, a group that now includes much of the corporate world. Yet the only viable short-term solution is to borrow more, to survive until the crisis passes. The result: companies will hit the next crisis with even more precarious debt piles."*

As Armstrong points out, *"in the US, non-financial corporate debt was about $10tn at the start of the crisis. At 47 per cent of gross domestic product, it has never been greater. Under normal conditions this would not be a problem, because record-low interest rates have made debt easier to bear. Corporate bosses, by levering up, have only followed the incentives presented to them. Debt is cheap and tax deductible so using more of it boosts earnings. But in a crisis, whatever its price, debt turns radioactive. As revenues plummet, interest payments loom large. Debt maturities become mortal threats. The chance of contagious defaults rises, and the system creaks."*

He goes on,*"this is happening now and, as they always do, companies are reaching for more debt to stay afloat. US companies sold $32bn in junk-rated debt in April, the biggest month in three year*s." Armstrong is at a loss to know what to do. *"Containing corporate debt by regulating lenders is also unlikely to work. After the financial crisis, bank capital requirements were made stiffer. The leverage merely slithered off of bank balance sheets and re-emerged in the shadow banking system. A more promising step would be to end the tax deductibility of interest. Privileging one set of capital providers (lenders) over another (shareholders) never made sense and it encourages debt."*

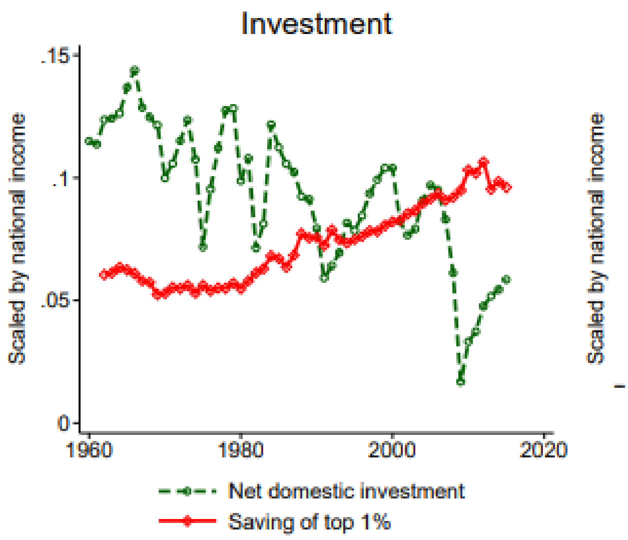
Martin Wolf, the FT's economics guru, reckons he has an answer. You see, the problem is that there is too much saving in the world and not enough spending. And this 'savings glut' means that debtors can borrow at very low interest rates in a never-ending spiral upwards. Wolf bases his analysis on the work of mainstream economists, Atif Mian and Amir Sufi. Mian and Sufi wrote a book a few years ago entitled House of Debt, which I reviewed at the time. It was considered by Keynesian guru, Larry Summers as *"the best book this century"!*

For the authors, debt is the main problem of capitalist economies, so all we have to do is sort it. What is odd about their argument is that, while they recognise that public sector debt was not the cause of the Great Recession as neoliberal austerity economists try to claim, they put the blame for the Great Recession not on corporate debt nor on financial panic, but on rising household debt. They claim that "*both the Great Recession and Great Depression were preceded by a large run-up in household debt… And these depressions both started with a large drop in household spending."* Mian and Sufi show with a range of empirical studies that the bigger the debt rises in an economy, the harder the fall in consumer spending in the slump. But they fail to note that it is a fall in business investment that presages crises in capitalist production, not a fall in household spending. I and others have provided much empirical evidence on this.

In their original book, Mian and Sufi do not address the reason for the inexorable rise in debt, corporate and household, from the early 1980s onwards. Now in new studies, cited by Martin Wolf, Mian and Sufi offer a reason. The spiral of (household) debt was caused by the rich getting richer and saving more, while the bottom of the income ladder got less and so saved less. The rich did not invest their extra riches in productive investment but hoarded it, or put it into financial speculation, or lent it back to the poor through mortgages. So household debt spiralled because a "savings glut" of the rich.

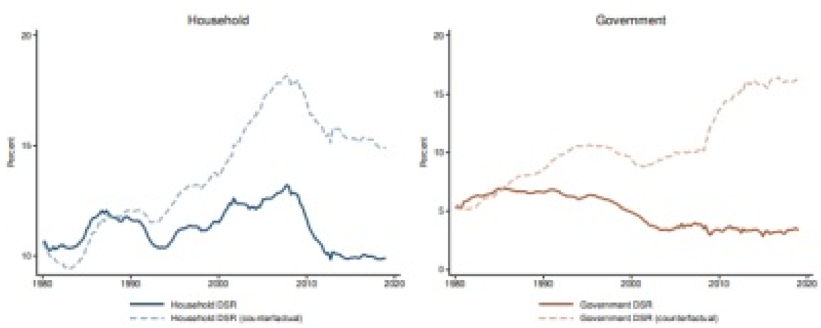
The rich got richer and saved more, while investment in productive assets slipped away.

So the 'savings glut' of the rich is the cause of the low investment and productivity growth of major capitalist economies.



Mian and Sufi argue in their second paper that because poorer households borrowed more, forced by low incomes and encouraged by low interest rates made possible by the savings glut of the rich, household debt spiralled to the point that it reduced 'aggregate demand' and slowed down economic growth in a form of 'secular stagnation'. This theory of 'indebted demand' is when *"demand is sufficiently indebted, the economy gets stuck in a debt-driven liquidity trap, or debt trap".* This is how much debt servicing would have cost if interest rates had not dropped after the 1980s.

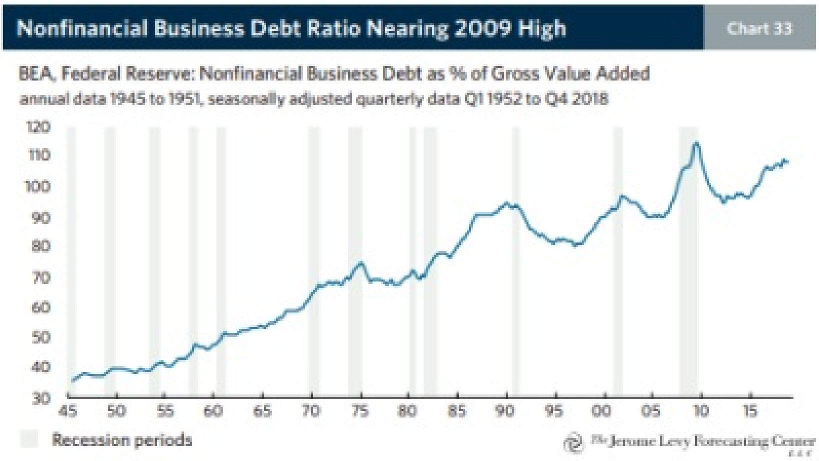
Figure 24: Hypothetical debt service costs had interest rates not declined.



See Appendix A for details.

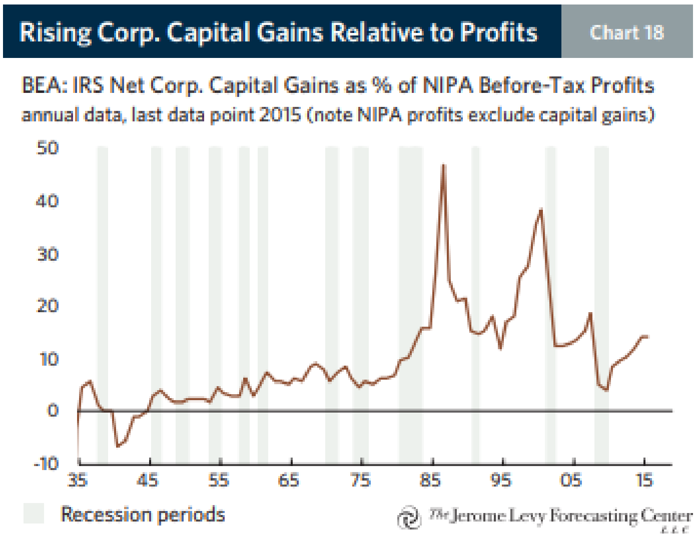
Wolf cites another version of the same argument that too much debt is caused by too much saving and is the cause of crises in capitalism. This comes from the post-Keynesian Minsky school. David Levy, head of the Jerome Levy Forecasting Center argues in a paper, Bubble or Nothing, that *"aggregate debt grew faster than aggregate income"* so *"making financial activity increasingly hazardous and compelling riskier behavior."* Levy sees the risk not in the size of the debt so much as its increasing fragility, as Minsky argued.

Unlike Mian and Sufi however, Levy correctly points to the importance of rising corporate debt, not household debt. The nonfinancial corporate sector's debt-to-gross-value-added ratio is near a new all-time high.

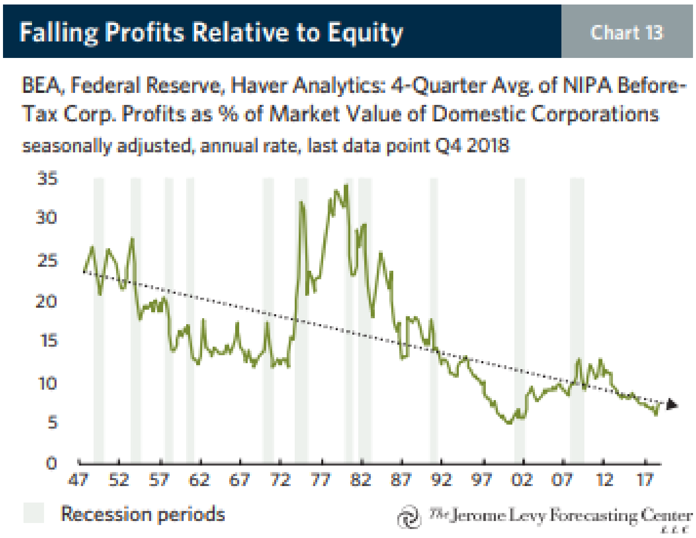


"*Moreover, if one excludes the largest 5% of listed corporations, the corporate leverage picture is more extreme and worrisome (chart 45). One indication of the risk associated with this increased corporate leverage is the profound rise in the proportion of companies with ratings just above junk levels in the past 10 years.*"

Again Levy shows *that "since the mid-1980s, the U.S. economy has been swept up in a series of increasingly balance-sheet-dominated cycles, each cycle involving to some degree reckless borrowing and asset speculation leading to financial crisis, deflationary pressures, and prolonged economic weakness."* In other words, rather than invest in productive assets, corporations switched to mergers and financial speculation so that much of their profits increasingly came from capital gains rather than profits from production.



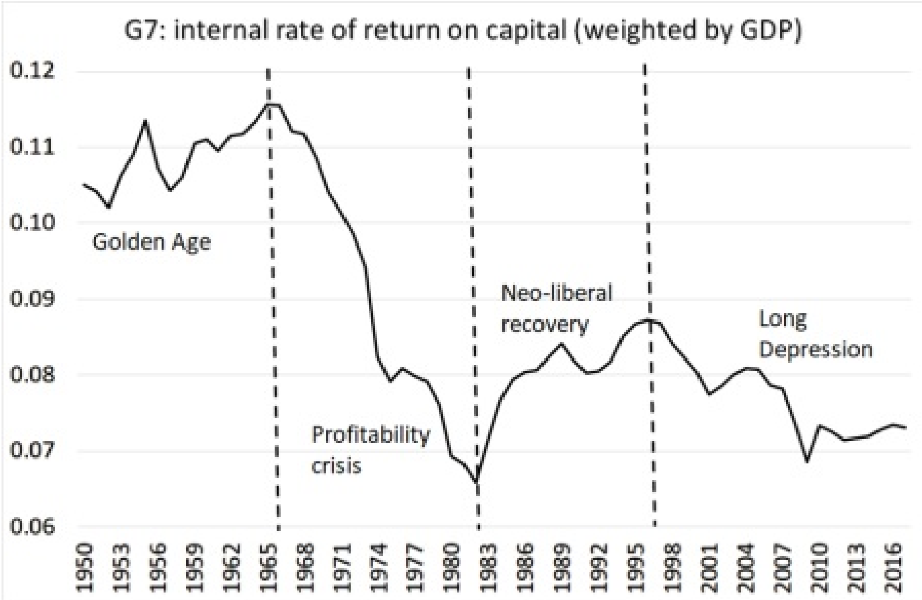
Profitability relative to the stock market value of companies fell sharply – or more precisely, the stock market value of companies rocketed compared with annual earnings from production.



Levy concludes that *"without balance sheet expansion (ie buying financial assets), it is exceedingly difficult to achieve the profits necessary for the economy to function. Moreover, once those profits are achieved, it is also exceedingly difficult to stop households and businesses from responding by borrowing and investing, thus reaccelerating balance sheet expansion and defeating the entire purpose. Bubble or nothing."*

What do we really learn from all this? Mian and Sufi emphasise rising inequality from the 1980s, a shift in income from the poorer to the top 1%, leading to a rise in household debt and a savings glut. But they do not explain why there was rising inequality from the early 1980s and they ignore the rise in corporate debt which is surely more relevant to capital accumulation and the capitalist economy. Household debt rose because of mortgage lending at cheaper rates, but in my view that was the result of the change in nature of capitalist accumulation from the 1980s, not the cause.

And actually Mian and Sufi hint at this. They note that the rise in inequality from the early 1980s *"reflected shifts in technology and globalization that began in the 1980s."* Exactly. What happened in the early 1980s? The profitability of productive capital had reached a new low in most major capitalist economies (the evidence for this overwhelming – see World in Crisis).



The deep slump of 1980-2 decimated manufacturing sectors in the global north and weakened labour unions for a generation. The basis was set for so-called neoliberal policies to try and raise the profitability of capital through a rise in the rate of exploitation. And it was the basis for a switch of capital out of productive sectors in the 'global north' to the 'global south' and into the fictitious capital of the financial sector. Ploughing profits and borrowed money into bonds and equities drove down interest rates and drove up capital gains and stock prices. Companies launched a never-ending programme of buying back their own shares to boost stock prices and borrowing to do so.

But this did not reduce 'aggregate demand'; on the contrary, household consumption rose to new highs. What ended this speculative credit boom was the turning down in the profitability of capital from the end of the 1990s, leading to the mild 'hi-tech' bubble burst of 2001 and eventually to the financial crash and Great Recession of 2008. A 'savings glut' is really one side of an 'investment dearth'. Low profitability in productive assets became a debt-fuelled speculative bubble in fictitious assets. Crises are not the result of an 'indebted demand' deficit; but are caused by a profitability deficit.

But how does capitalism get out of this debt trap? This is the debt dilemma.

Wolf and Mian and Sufi reckon that it is through the redistribution of income. Wolf cites Marriner Eccles, head of the US Federal Reserve in the Great Depression of the 1930s. In 1933, Eccles told Congress, *"It is for the interests of the well to do . . . that we should take* *from them a sufficient amount of their surplus to enable consumers to consume and business to operate at a profit."* So you see, it is in the interests of the rich to let the government take some of their money to help the poor to boost consumption.

Mian and Sufi say: *"Escaping a debt trap requires consideration of less standard macroeconomic policies, such as those focused on redistribution or those reducing the structural sources of high inequality."* So we need to reduce the high inequality by addressing *"structural sources"*. In my view, that means addressing structural features like the rising concentration and centralisation of the means of production and finance, not just a rising inequality of income.

Indeed, Wolf appears to take a more radical view: *"we have a huge opportunity now to replace government lending to companies in the Covid-19 crisis with equity purchases. Indeed, at current ultra-low interest rates, governments could create instantaneous sovereign wealth funds very cheap!"* So the state should intervene and buy up the shares of those companies with large debts that they cannot service. But in effect, this would mean governments buying weak companies that are already 'zombies', while the powerful and profitable corporations remain untouched. This is government aiming to save capitalism, not replace it. Here Wolf follows closely the line of the FT itself that *"Free markets must be protected through the pandemic, with sensible and targeted state intervention that can help capitalism to thrive post-crisis."*

In contrast, Levy is pessimistic that there is any solution that avoids slumps: *"there is neither a realistic set of federal policies to painlessly solve the Big Balance Sheet Economy dilemma nor even a blueprint of what the optimal policies should be."* Marx would agree that the only way out of this slump is through the slump. Former IMF chief, the (infamous) Dominic Strauss Kahn reckons that the strategists of capital must just allow the liquidation of the zombies and unemployment to rise because then *"the economic crisis, by destroying capital, can provide a way out. The investment opportunities created by the collapse of part of the production apparatus, like the effect on prices of support measures, can revive the process of creative destruction described by Schumpeter."*

To end the spiral of debt and fictitious capital will require much more than taxing the rich more or buying up weaker companies with government debt. As Wolf says: *"We will have to adopt more radical alternatives. A crisis is a superb a time to change course. Let us start right now."* Of course, he means to save capitalism, not replace it.