How to escape the trap of excessive debt

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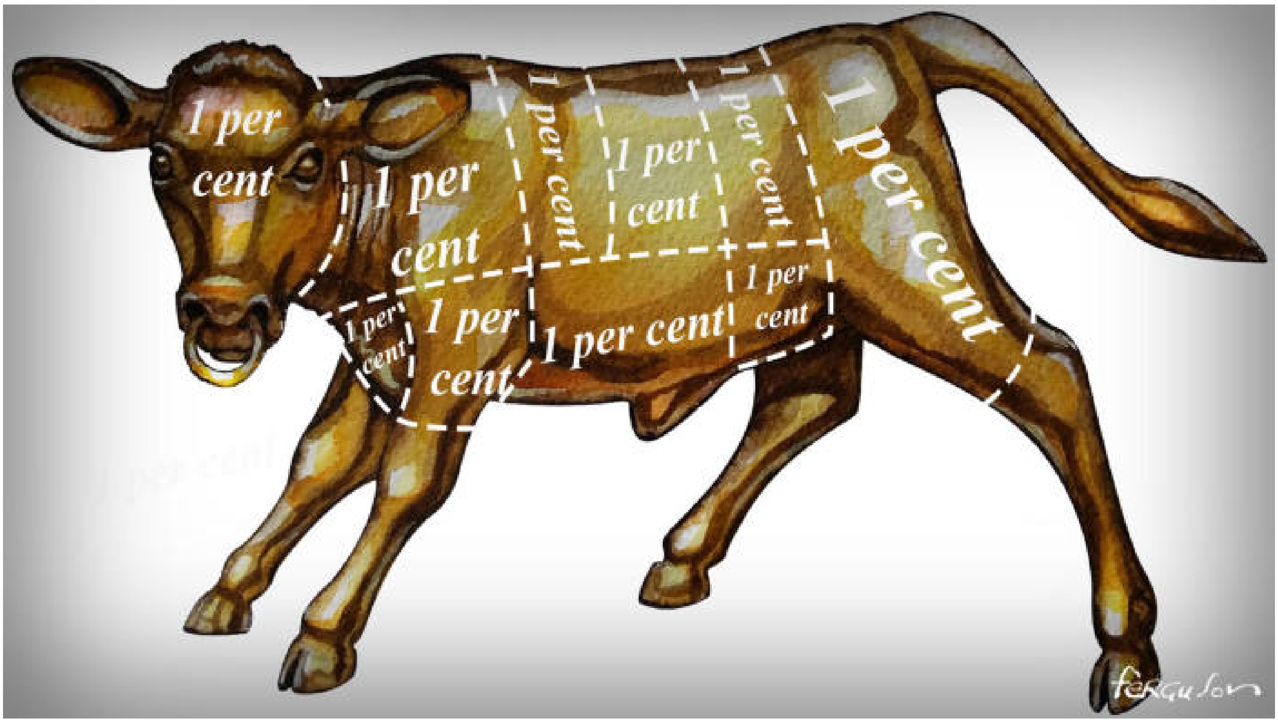
Martin Wolf, The Financial Times, May 5, 2020



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"It is utterly impossible . . . for the rich to save as much as they have been trying to save, and save anything that is worth saving." Marriner Eccles, Congressional testimony 1933.

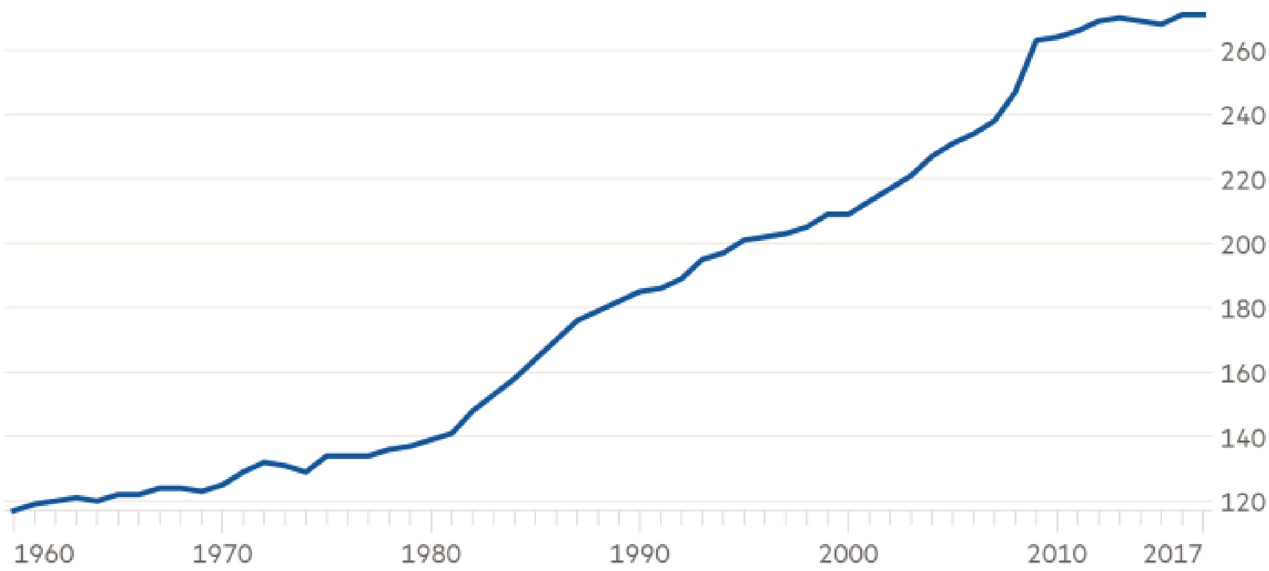
Debt creates fragility. The question is how to escape from the trap. To answer it, we need to analyse why today's global economy has become so debt-dependent. That did not happen because of the idle whims of central bankers, as many suppose. It happened because of an excessive desire to save relative to investment opportunities. This has suppressed real interest rates and made demand far too reliant on debt.

Two recent papers illuminate both the forces driving this rise in leverage and its consequences. One, directly related to the views of Eccles, who chaired the US Federal Reserve from 1934 to 1948, is on "The Saving Glut of the Rich and the Rise in Household Debt". The other, on "Indebted Demand", explains how debt overhangs weaken demand and lower interest rates, in a feedback loop. The authors of both include Princeton's Atif Mian and Chicago's Amir Sufi, well known for their fine past work on debt.

As Eccles said so clearly, beyond a point, inequality weakens an economy by driving policymakers into a ruinous choice between high unemployment or ever-rising debt. The paper on the savings glut makes two points. First, rising inequality in the US has resulted in a large increase in the savings of the top 1 per cent of the income distribution, not matched by a rise in investment. Instead, the investment rate has been falling, despite declining real interest rates. The rising savings surplus of the rich has been matched by the rising dissaving, or consumption above income, of the bottom 90 per cent of the income distribution.

The ever-rising global debt mountain

Total debt as a % of GDP, weighted average of 14 advanced economies*



* G7, Australia, Finland, New Zealand, Norway, Portugal, Spain, Sweden. Debt includes credit to households, government and non-financial corporations

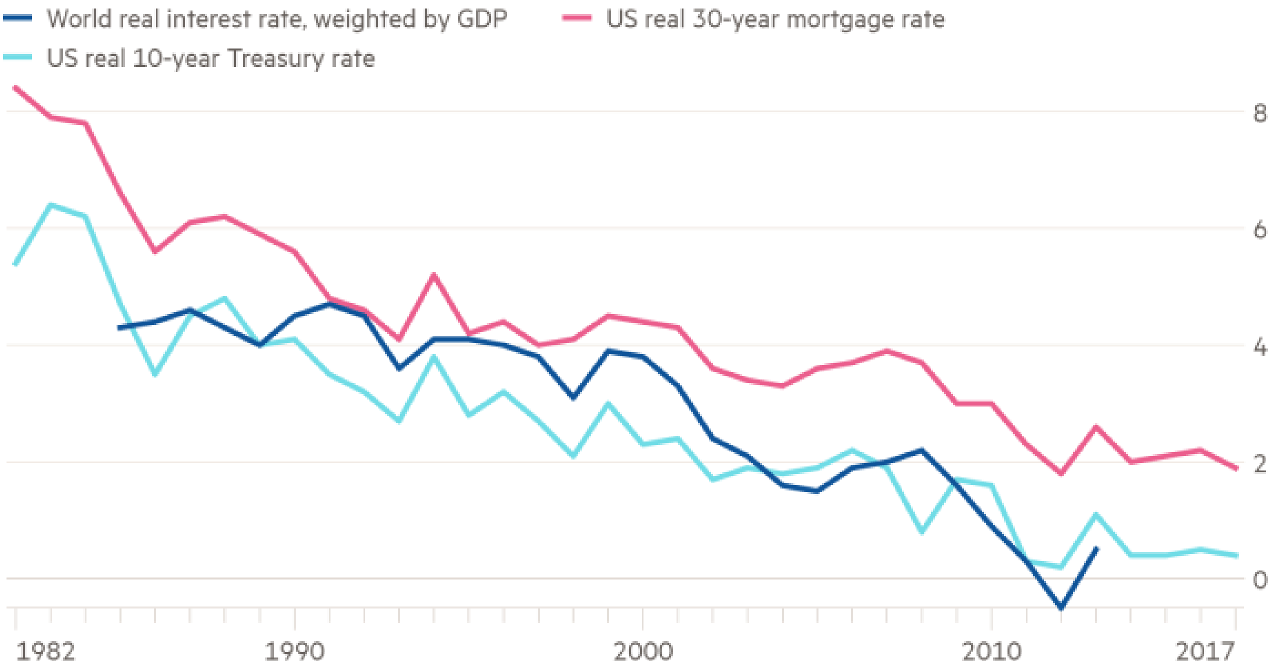
Source: Mian, Straub & Sufi; IMF; Jorda-Schularick-Taylor Macrohistory Database; New Zealand Treasury

The savings of the rich might have led to a current account surplus, as in late-19th-century UK. But the rich of the rest of the world have sought to accumulate US assets, and so generated a persistent US current account deficit. Except when the pre-financial crisis housing bubble drove up private investment, this has also remained too weak. The chief users of excess foreign and domestic savings have been less well-off households and the government.

There is a clear link between the saving of the rich and dissaving of the less rich, and the accumulation of credit and debt. Since 1982, the decline in net indebtedness of the rich has been matched by the rise in indebtedness of the bottom 90 per cent. This is why the argument that low interest rates hurt the less well off is absurd. The less well off are not large net creditors. The rich hold claims on the less rich, not only directly, via bank deposits, but via equity holdings in businesses that also hold such claims. This phenomenon of rising household debt and rising inequality is not unique to the US. It is widespread.

The progressive fall in real interest rates

Per cent

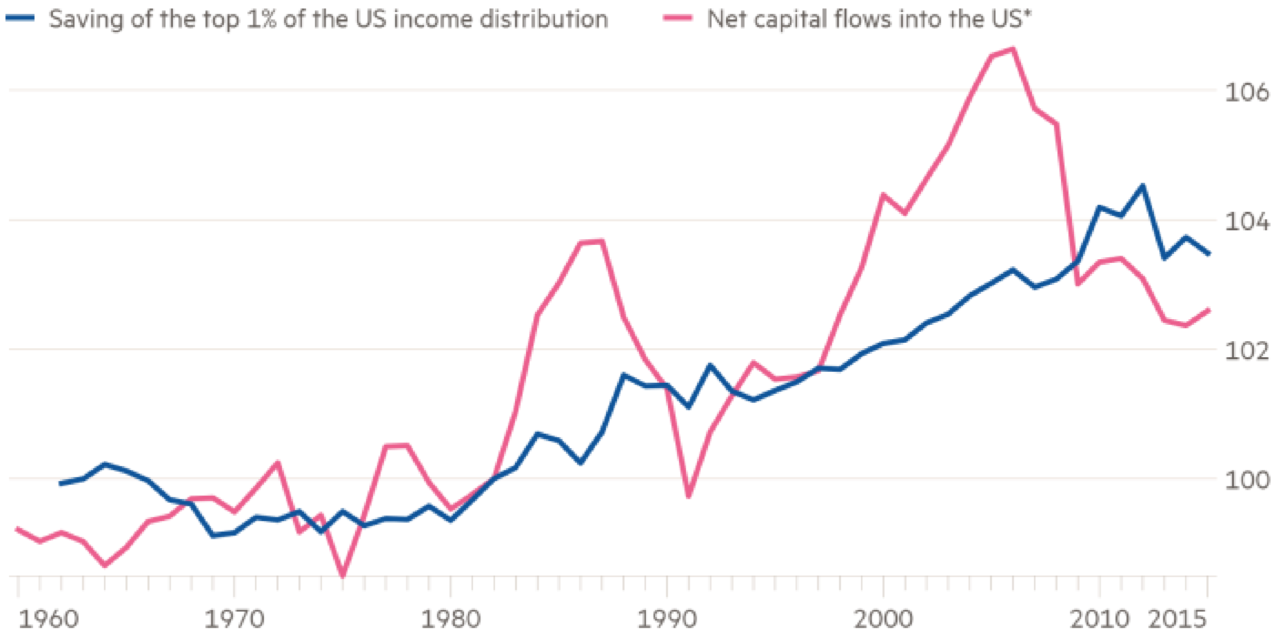


Source: Mian, Straub & Sufi; Jorda-Schularick-Taylor Macrohistory Database

Why does the rising debt matter? One answer, as David Levy argues in *Bubble or Nothing*, is that the economy becomes increasingly driven by finance and fragile, as borrowers become ever more overburdened. Another is the idea of "indebted demand" — a close relative of the idea of "balance-sheet recessions" propounded by the Japanese economist, Richard Koo. As debt soars, people are ever more unwilling to borrow still larger amounts. So interest rates have to fall, to balance supply with demand and avoid a deep slump. In these ways, we have ended up where we were even before Covid-19, with real interest rates at zero. This is one mechanism driving what Lawrence Summers has called "secular stagnation".

The domestic rich and foreigners are equally big savers for the US

Shares of US national income (1982=100)

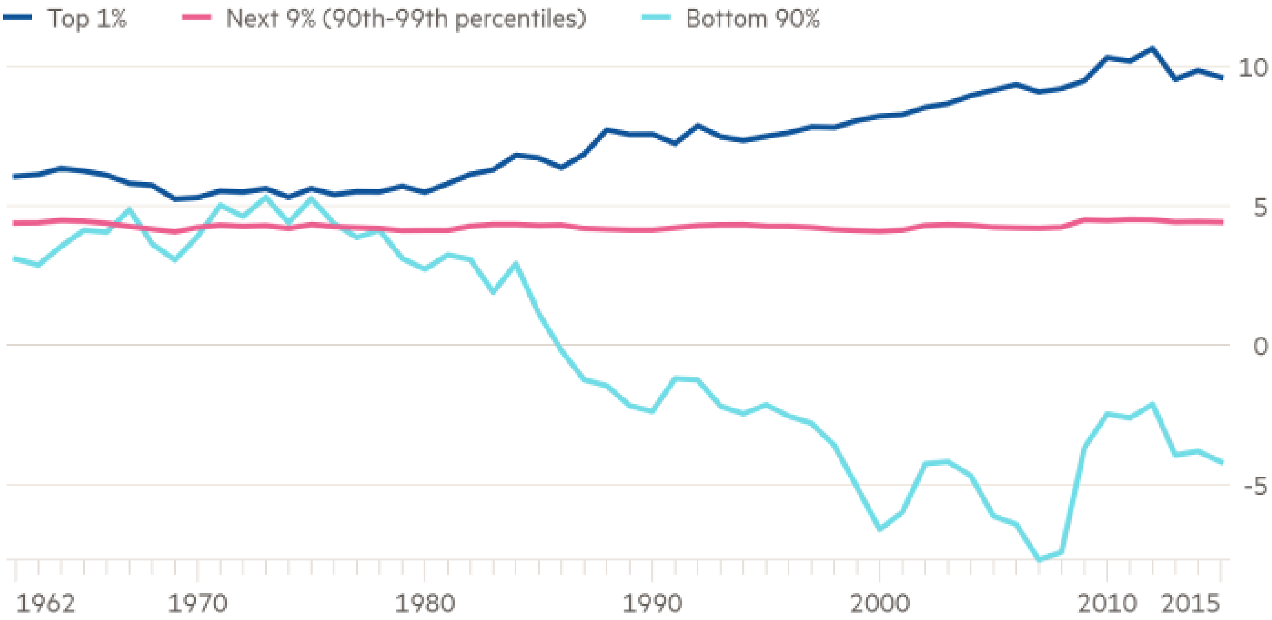


* inverse of the current account balance
Source: Mian, Straub and Sufi

We must focus on the US first, because that is where global demand and supply tend to balance. But similar phenomena of rising inequality and soaring savings are to be seen in other big economies, notably China and Germany. The former used to export its excess savings to the US, but now absorbs it in wasteful investment at home. The latter has driven trading partners into rising debt in the eurozone and beyond.

The savings glut of the US rich has grown enormously, while the majority increasingly dissaves

Savings of groups in the US income distribution, as a % of national income

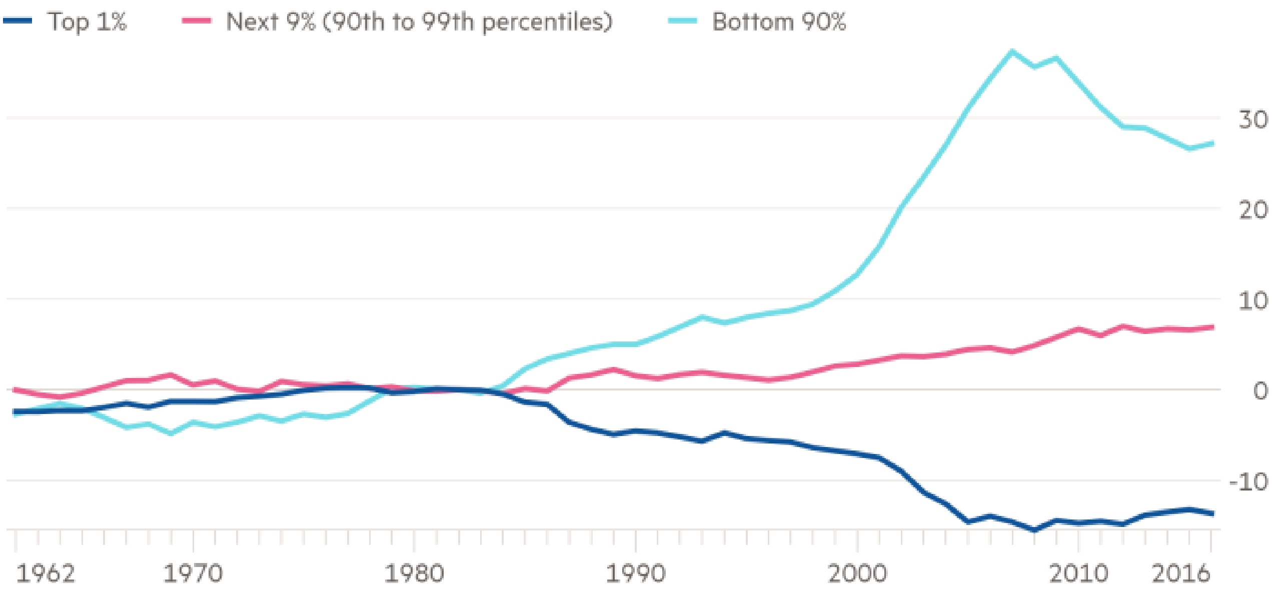


Source: Mian, Straub & Sufi

So, how are we to escape from the debt trap? One step is to diminish the incentive to finance businesses with debt, rather than equity. The obvious way to do so is to eliminate the preference of the former over the latter in almost all tax systems. It is also possible, as Profs Mian and Sufi argued in an earlier book, to shift from debt to equity financing of housing. In addition, 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 cheaply.

The US rich have become much bigger creditors, while the rest have become much bigger net debtors.

Changes in net household debt as a share of national income relative to 1982, across the US income distribution (% points)



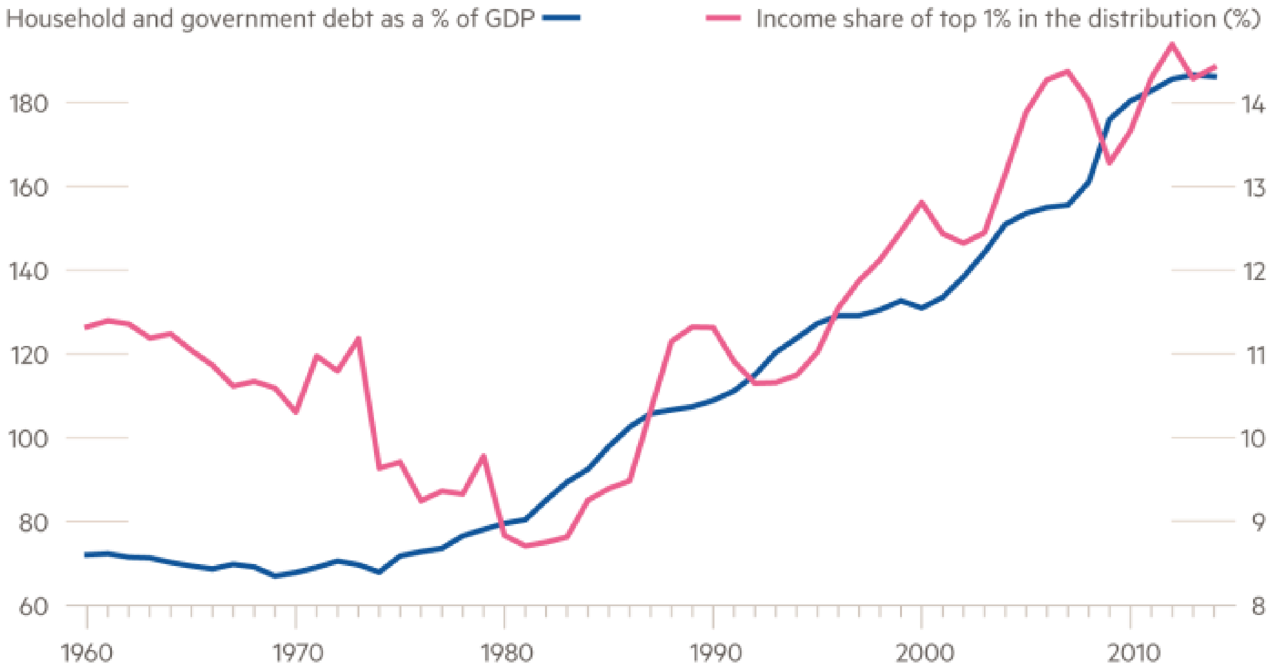
Source: Mian, Straub & Sufi

Yet none of this would fix the ongoing dependence of macroeconomic stability on ever more debt. There are two apparent solutions. The first is for governments to keep on borrowing. But, in the very long term, this is likely to lead to some sort of default. The well-off, who are the principal creditors of government, are bound to bear much of the costs, in one way or the other. The alternative is to shift the distribution of income, in order to create more sustainable demand and so stronger investment, without soaring household debt.

In 1933, Eccles also 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.” That happened, partly by accident and partly deliberately, after the second world war. Ever-rising household and government debt will not stabilise the world economy forever. Nor should asset-price bubbles remain so central to our economy. We will have to adopt more radical alternatives. A crisis is a superb a time to change course. Let us start right now.

Inequality and debt have risen in lockstep

Weighted averages across 14 advanced economies*



* G7, Australia, Finland, New Zealand, Norway, Portugal, Spain, Sweden
Source: Mian, Straub & Sufi; World Inequality Database; IMF; Jorda-Schularick-Taylor Macrohistory Database; New Zealand Treasury

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Letter in response to this column:

Tackling inequality requires investment-focused fiscal policies / From Yves-Andre Istel, Senior Adviser, Rothschild & Co, New York, NY, US