CHICAGO POLITICAL ECONOMY GROUP

On Debt Updated

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Debt is complex. There are four main areas of debt: non-financial corporate debt, financial corporate debt, household debt and government debt. They are quite different in their effects on the economy and their importance in understanding crisis.[1]

What do we mean by debt? Debt is created when a company or an individual takes out a loan or sells a bond or in any way enters into an agreement to pay the money back, usually with interest. All kinds of institutions make loans from banks to private companies to governments. The types of debt reflect the types of borrowers.

Let's examine each of the different types of debt and its impact on the econopmy.

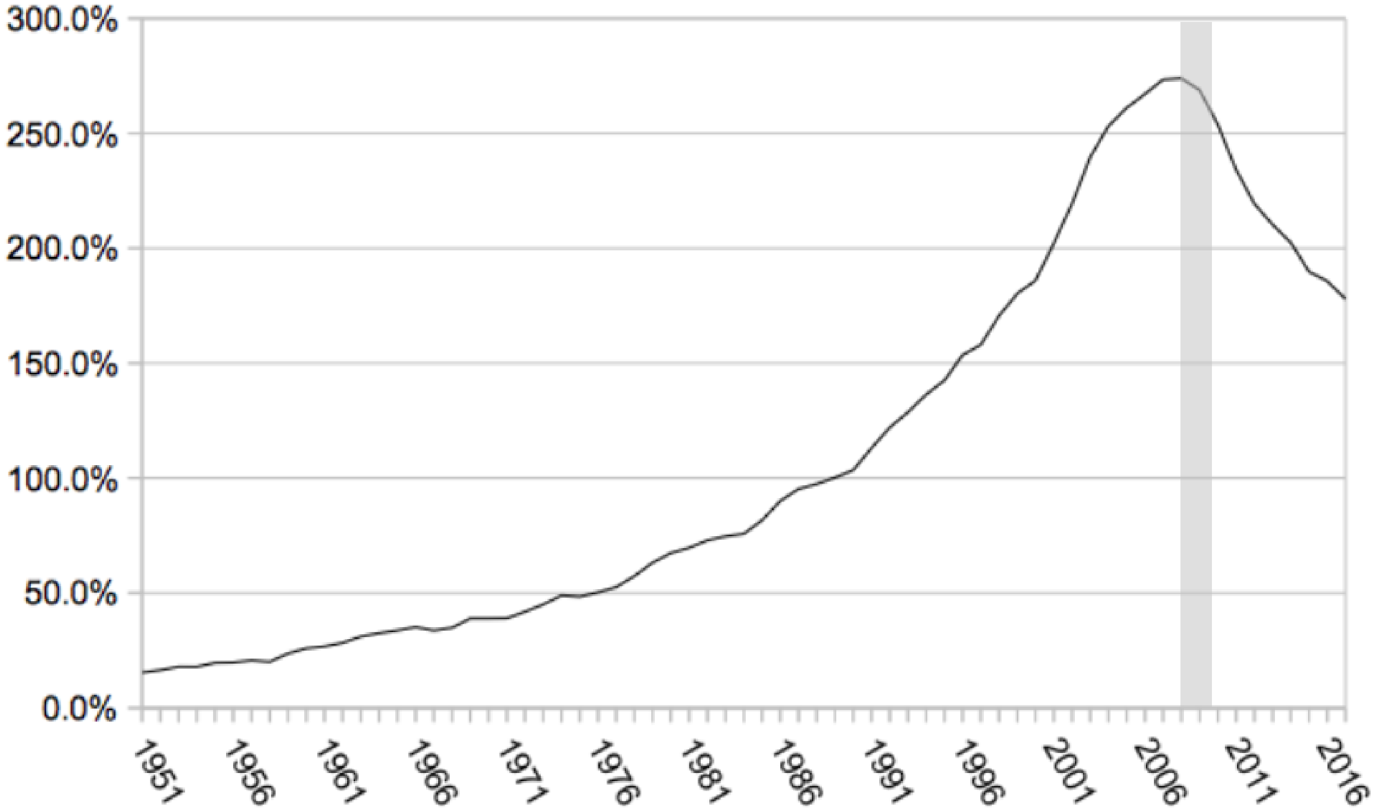
Non-financial corporate debt (see Chart 1) has historically been used to fund production through what is called productive investment: investment in buildings, machines, inventories, etc. Right now, corporate debt is at extremely high levels, about $9 trillion, unmatched since just before the Great Recession of 2008. A report by Matt Egan of CNN points out that the richest one percent of corporations carry more than half of the debt.[2] The largest seven companies alone, control something on the order of 12.5 percent. Instead of investing productively, much of the corporate debt today is used to buy back financial instruments to maintain stock prices and profitability. Buying the company's own stock drives the price up, rewarding share holders. Finanical investments may yield a higher return than productive investments, increasing profitability. These actions have led to a decrease in productive investment and is a reason (not the only one) for the decline in productivity growth in the productive sector. The rest of the corporate debt is held by smaller companies, who do not have the wherewithal to maintain the load they are carrying. This has meant they have a very large interest payment burden. If the situation develops where this debt cannot be paid, that can (and has) lead to economic crisis. The peaks in borrowing shown in the chart correspond to the recessions of 1990-1991, 2001 (the "dot-com" crisis), and the Great Recession of 2007-2009. The fact that non-fginancial corporate debt is again at historically high levels today, may indicate another crisis is imminent.[3]

Chart 1: Non-Financial Corporate Debt Load

Source: Federal Reserve

Debt in the financial sector has also grown astronomically. The difference is that debt in the non-financial sector – at least in part – finances actual production. Debt in the financial sector finances futures, options, derivatives and other financial instruments that are not part of the productive economy. In 1951, financial debt was a mere 15 percent of non-financial debt. Since then, both have grown – non-financial debt by about 11 times and financial debt by a whopping 131 times – so that financial debt is now just short of twice non-financial debt. At its peak in 2008 (the period of the Great Recession), it was 274 percent – just short of three times – of non-financial debt. The decrease shown in the chart since the Great Recession has not been due to a decrease in financial debt; it has been due to the more rapid growth of non-financial corporate debt.

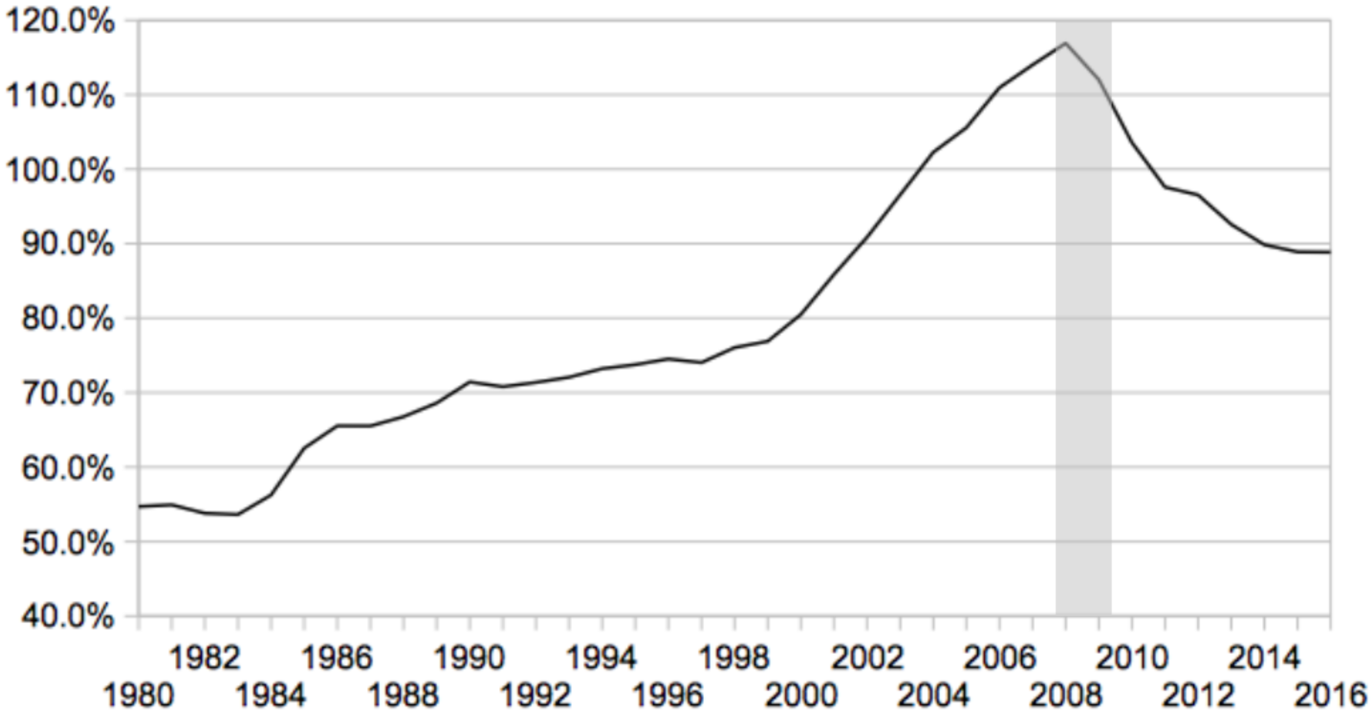
Chart 2: Financial Debt as a Percent of Non-Financial Debt



Source: Federal Reserve

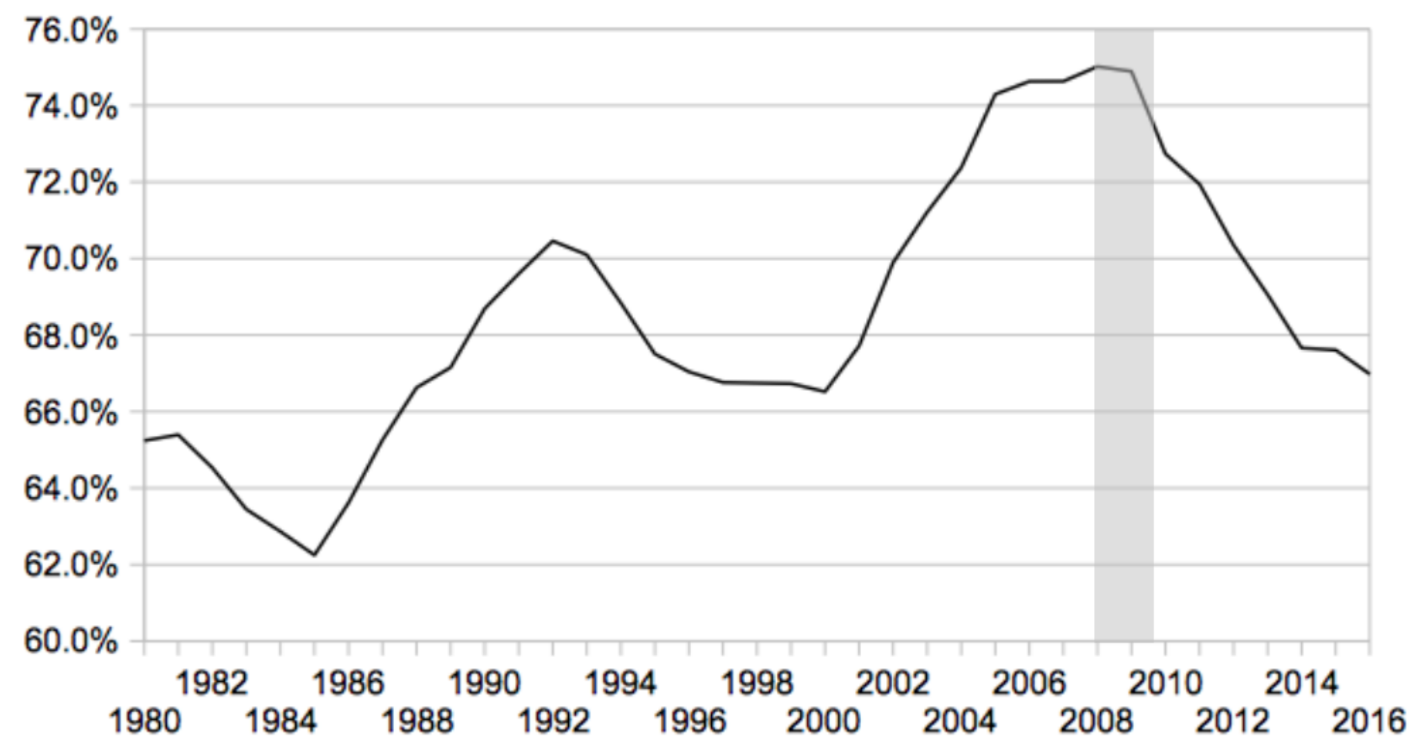
Household debt (See Chart 3) is of basically two types. The largest part is mortgage debt (see Chart 4) where people are buying their own houses. Almost two-thirds of households in the US own their homes (or are paying banks for them). The rest of household debt is the burden of credit card and revolving debt. The total sum of household debt is a major load on families. As households take on more debt, their payment obligations increase, leaving fewer funds for the necessities of life and decreasing demand for them. The irony is that debt has been promoted by capital (banks and credit card companies) to increase the circulation of commodities, but the rising debt burden could have the opposite effect when the interest payments become too large a proportion of total expenditures. As is shown in the charts, personal debt as a proportion of personal income peaked at the height of the Great Recession when people were hurting and has since declined, but remains high. Total household debt is still 90 percent of personal income. Mortgage Debt as a proportion of total debt also peaked during the Great Recession, which was brought on by the financial crisis over the housing market. It has since fallen back to more historic levels.

Chart 3: Household Debt as a Percent of Personal Income



Source: Federal Reserve

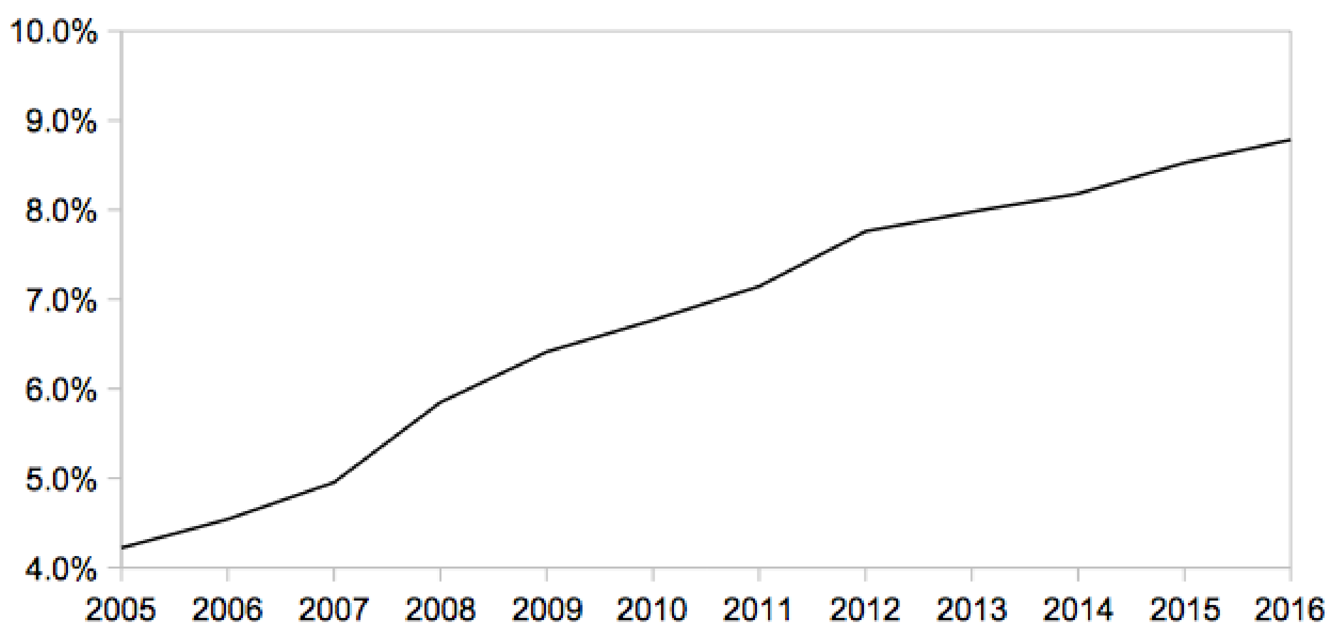
Chart 4: Mortgage Debt as a Percent of Household Debt



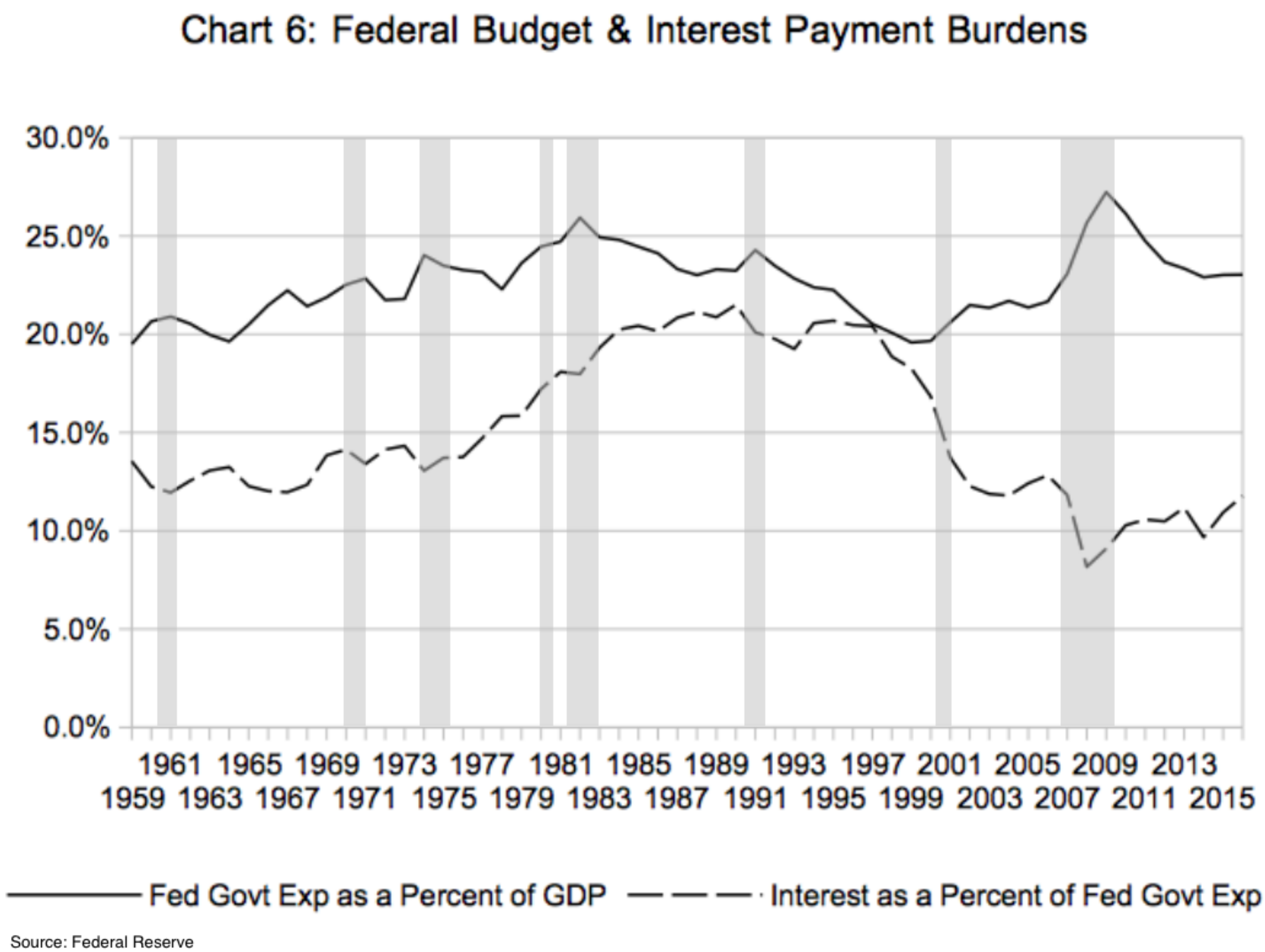
Source: Federal Reserve

A special note needs to be made about student debt (see Chart 5) which currently stands at over $1.6 trillion. This is a major burden on those who have attended college and has the effect of making education worth less financially worthwhile than in the past. Education has always been seen in this country and a way "up and out." Today, the increase in student debt, which has risen astronomically over the last decade, makes the return on education questionable. Student debt has also been made legally binding beyond normal restrictions; it is almost impossible to get out from under its burden except by paying off virtually every dollar of it. Student debt also restricts productivity growth, which depends in large part on the education of workers. The burden of student loans – principal and interest – has increased, in just over a decade, from about 4 percent of personal income to almost 9 percent: a more than doubling. The actual burden on students is worse than these numbers reflect, because personal income includes everyone, with or without student debt. The burden just on those with the student debt is much worse, but the data to reveal that is not available.

Chart 5: Student Loans as a Percent of Personal Income



Government debt has many ramifications for the economy. Government debt has grown dramatically over the last 20 years. It is being used by conservatives as an excuse for cutting benefits and government programs. But the real burden of Government Debt (see Chart 6) varies. The burden of debt should be seen in its overall proportion to total Government Spending and to Gross Domestic Product (GDP). As the top line in the chart shows, while the ratio of government spending to GDP has risen and fallen with the economy, it has not risen substantially over the last nearly 60 years. As the bottom line in the chart shows, interest payments on the government debt have actually fallen as a percent of total government spending. This is due in part to the extremely low – often even negative – interest rates since the Great Recession. In short, debt – including government debt – is very inexpensive. Also, government spending is a spur to the economy, increasing economic activity.



To the degree that it expands the money supply, government spending fosters inflation and lowers the dollar in international trade, making US goods less expensive overseas and imports more expensive here. This seems to have been countered by the Quantitative Easing undertaken by the European Union. The increase in the money supply may also spur inflation. Inflation has been low. Although the Consumer Price Index (CPI) understates the rate of increase in prices the average worker feels, it has been very low over the last decade: below 2 percent for almost all of the period. Interest rates have also been low; they are currently below 2.5 percent. This meant that the real rate of interest – where we subtract the rate of inflation from the interest rate charged on government debt – has been very low, possibly even negative. Low real interest rates have fostered the boom in debt and borrowing because credit is cheap. It has also fostered speculation, where money capital searches for higher rates of return in more risky ventures.

There is a lot of hype about debt. Hopefully looking at the different types of debt and how they affect aspects of the economy clarifies some of the issues. It is a reality, however, that the overall amount of debt has increased beyond historical levels and will remain an issue of concern.

References

[1] Thanks to Bill Barclay, Ron Baiman, Mark Porter-Webb and Tim Shenk for their useful comments to improve earlier drafts of this paper.

[2] Matt Egan, “The $6.3 trillion debt binge: American companies have never owed this much,” accessed on July 1, 2018 at http://money.cnn.com/2018/07/01/investing/stocks-week-ahead-debt-bubble/index.html.

[3] Mauldin Economics, “Thoughts from the Frontline: Credit-Driven Train Crash, Part 1,” accessed on July 3, 2018 at http://www.mauldineconomics.com/frontlinethoughts/credit-driven-train-crash-part-1.