A MATTER OF LIFE IN DEBT

Can we move away from using debt as a way to tackle economic downturns?

By Deepika Deshpande

Economics is not a natural science. Seldom can economic ideas be tested objectively and even when they can, seldom do they carry universal applicability. Notwithstanding this subjectivity, there are some immutable principles that hold true regardless of time and place. One such idea that comes close to being an 'immutable truth' is that the amount we borrow cannot exceed the amount we can repay, or, more generically, growth in the level of debt cannot indefinitely exceed growth in the level of income. This is common sense, so it requires no sophisticated financial knowledge on our part to understand it. Strangely, however, in the context of today's historic levels of global debt, this fundamental wisdom seems to have been forgotten. This article explores the drivers and implications of global debt, and debates possible solutions to the debt problem, particularly those that address the root causes.

Debt: A brief history

Our relationship with debt has a long and complex history. Anthropological evidence suggests that debt was a common feature of early human settlements, and it was in fact a precursor to money. In that sense, managing debt is not a new issue that our financially evolved societies have to contend with. In his 2018 book *...and forgive them their debts: Lending, Foreclosure and Redemption From Bronze Age Finance to the Jubilee Year*, Michael Hudson offers an interesting historical account of the management of debt in ancient societies. His research on Bronze Age Mesopotamia suggests that official debt annulments were a commonly used fiscal tool to restore financial stability. When the burden of debt on the citizenry became excessive and debts could not be repaid, the cancellation of debts became the only practical solution to prevent a social and economic collapse.

While the world has experienced multiple 'debt cycles' characterised by periodic ebbs and flows, the secular trend since the mid-20th century has been climbing. The global debt database compiled by the International Monetary Fund (IMF) aggregates public and non-financial private debt dating back to 1950, and reveals that total debt to gross domestic product (GDP) exceeded 225 percent in 2016, and has in fact more than doubled since 1950. Updated figures on the rising tide of debt are available from the Institute of International Finance (IIF) Global Debt Monitor, and they not only indicate that global debt reached US$255 trillion or 322 percent of global GDP in 2019, but also that it is set to exceed US$257 million by the end of Q1 2020.

There have been four significant debt peaks in the 20th century. Three of these peaks–the high levels of debt after WWI, the Great Depression, and WWII–primarily affected advanced economies, while the fourth, which occurred during the debt crisis of the 1980s, impacted emerging markets.[1] The retreat from the peak levels of debt in each of these episodes was achieved mostly through a combination of defaults or restructuring, inflation, and financial repression or some form of forced lending. Generally, high levels of leverage are accompanied by lower levels of economic growth, and this makes deleveraging a painful and prolonged process. In fact, the debt peak after WWII was the only one that was partially reduced by GDP growth in the form of the post-war boom.

Debt in the 21st century

The rise in debt in recent times is, to some extent, being driven by exogenous socio-economic and demographic trends. Longevity and ageing populations are forcing governments to spend more on welfare, and this is a trend that is not likely to reverse anytime soon. Rising inequality may also have a role to play, since the rich tend to save more while the poor depend on debt for consumption.

There is also a more specific reason contributing to the growth of debt. Keynesian thinking that emerged in the aftermath of the Great Depression advocated the use of increased government spending and reduced taxes to provide an important counter-cyclical demand boost during recessions. The trade-off for any inflationary pressure due to increased spending would be reduced unemployment. These ideas provided the theoretical basis for the use of fiscal policy interventions to smoothen out downturns. When Keynesian economics could not address the stagflation of the 70's, monetarism or the use of money supply and interest rate changes to influence economic activity began to gain in popularity. Today, both fiscal and monetary ideas feed into the policy toolkit available to governments to address recessions and downturns. Research by Hamilton Bolton and Tony Boeckh of Bank Credit Analyst indicates that prior to the ascendancy of these ideas, leverage would build up in times of economic expansion, but there would be a return to financial sobriety during recessions. This pattern resulted in particularly painful economic downturns, whose qualities of acute bleakness and deep despair were captured in the novels of John Steinbeck, and the photographs depicting breadlines during the Weimar Republic period in what is now Germany.

Today, thanks to the sophistication of theories, tools and institutions, economic crises are unlikely to hurt as much as they did in 1929 when the Great Depression started. Even though debates on the use of interventionist policies versus the reliance on market self-correction mechanisms surface from time to time, fiscal support and quantitative easing by central banks have now become widely adopted policy responses to crises. It is almost inconceivable that governments and policymakers would sit idle while economic cycles painfully re-adjust themselves.

The collapse of the sub-prime market, which triggered the Global Financial Crisis (GFC) of 2007-2009, is a good case in point. Economists Alan Blinder and Mark Zandi estimate that after the passing of the American Recovery and Reinvestment Act (ARRA) of early 2009 and the adoption of other smaller stimulus measures, fiscal initiatives aggregated to almost seven percent of GDP.[2] Simultaneously, the U.S. Federal Reserve Bank ('the Fed') undertook a significant programme of monetary expansion that included aggressive interest rate reductions, and the direct injection of money through quantitative easing programmes. Consequently, the Greenspan Put of the late 1980s re-materialised as the Bernanke Put during the GFC. More recently, it has re-emerged as the Powell Put after the Covid-19 crisis broke out. When the markets initially shrugged off the US$2-trillion stimulus announcement in early March 2020, the Fed doubled down on its offer. Former European Central Bank President and economist Mario Draghi's emphatic promise in a 2012 speech to do "whatever it takes" has since then not only become the default strategy of policymakers, but is also increasingly becoming what markets expect when a crisis arises.

John Mauldin in his book *Endgame* constructs an excellent analogy between economies and forest fires. The state of California in the U.S. and Baja California in Mexico have similar types of forests and vegetation, but very different fire control policies. Paradoxically, Baja California has many more small fires but almost no major fires, whereas California has limited small fires but has witnessed many devastating high-intensity fires. In California, small fires are put out regularly by firefighters. In Baja California, they are not. Small periodic fires clear up leaf litter, dry brush, and other flammable material, and thus provide an important defence against destructive wildfires. Mauldin indicates that a similar logic may be at work in an economic context: small periodic corrections keep leverage levels in check, but efforts to ameliorate them in the short term may in fact exacerbate their effects in the fullness of time.

While such measures help smooth out recessions, they rarely allow for a complete return to normality. Interventions provide vital shock absorption in the short run; however, they could set into motion a debt supercycle that we will find hard to extricate ourselves from.

The root problem of using this approach, however, is not the unprecedented growth of debt. It is not even the fact that each successive crisis becomes more difficult to manage, since we approach it with a higher burden of debt. The real issue is that repeated use of a tool that provides short-term relief erodes the motivation to identify and address systemic problems. The manifest takes precedence over the latent, the immediate over the looming. To quote French entrepreneur and diplomat Jean Monnet, "People only accept change in necessity and see necessity in crisis." Rescue operations in the form of quantitative easing have removed the sting of the crisis and hence the appetite for fundamental change. There is no debt purgatory anymore.

Finding other ways to pay debt

Regardless of the reasons for the increase in debt, it is very unlikely that economic growth will be able to continue contributing to debt servicing as it had during the post-WWII debt boom. An impressive commentary by Dietrich Vollrath in his 2020 book *Fully Grown: Why a Stagnant Economy is a Sign of Success* unpacks the 25 percent decline seen in U.S. GDP growth between the second half of the 20th century and the first 20 years of the 21st century. His analysis indicates that 80 percent of the deceleration has been driven by demographics (ageing, and declining fertility rates), and reductions in total

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TOTAL DEBT TO GROSS DOMESTIC PRODUCT (GDP)

factor productivity resulting from a shift to a service-focused economy. These trends are not likely to reverse.

Addressing the debt problem involves some obvious solutions such as ensuring productive use of debt, removing unnecessary subsidies, and curbing corruption, while improving tax policies and compliance are an obvious solution to better managing debt. However, it is unlikely that these alone will be adequate to resolve the issue.

While the discussion so far has pointed out the problems related to the current style of economic management with respect to debt, what are the possible solutions? A good starting point would be to recognise the fact that every incremental build-up of debt brings diminishing marginal returns in terms of economic growth. It may therefore be advisable to shift our focus from debt-fuelled growth to a more balanced set of indicators. This is not a new idea. Herman Daly proposed the theoretical reasoning behind the limit to growth concept in his book *From Uneconomic Growth to a Steady-State Economy* in the early 70's. Many of the ideas behind the concept of uneconomic growth originated from the thinking on ecological economics.

The global economy has grown too large to ignore the finitude of our world, and any incremental growth will extract more in terms of cost than what it will deliver in terms of benefits. Additional considerations are fuelling the calls for re-evaluating growth-centred policies, foremost amongst those being the rising level of inequality in income and wealth. Danny Dorling in his recent book *Slowdown–The End of the Great Acceleration–and Why It's Good for the Planet, the Economy, and Our Lives* argues that such a slowdown is not only inevitable but also desirable. He marshals compelling evidence to prove that human progress has been slowing since the 1970s, and propounds that it is a path to stability and happiness.

Unfortunately, we have no available precedent for navigating a deceleration, other than managing it as a downturn. The accepted logic underpinning our economic, social, and cultural ideologies puts an emphasis on growth, consumption and acceleration. We will therefore need a new theoretical framework to meet the requirements of a decelerating world. To some extent, the current Covid-19 crisis has provided a natural experiment for exploring new ideas. In a recent interview, Christina Romer, former Chair of former President Barack Obama's Council of Economic Advisors, was asked which of the previous crises–the Great Depression or the Great Recession–offered the appropriate model for tackling the Covid-19-induced recession.

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Her answer categorically emphasised that this recession is different. Under the current circumstances, it is unlikely that fiscal or monetary stimulus, regardless of quantum, can fully bring back consumer demand, and nor would we want it to, given that the underlying problem is one of public health and safety. As such, the traditional fiscal and monetary solutions have limitations.

Other than economic theory, we will also need cultural norms and values to evolve. What we consume, how much we consume, how we price social and environmental externalities, and how we distribute the rewards of labour, are greatly defined by cultural mores, and these have a profound impact on economic outcomes. The political commitment essential for resetting our course cannot run ahead of what is socially and culturally acceptable to the underlying constituency concerned.

How we should solve the problem of debt remains a matter of conjecture. What is not a conjecture is the tautological conclusion of Stein's Law–if something cannot go on forever, it will stop. And despite the many millennia that separate us from the ancient Assyrians, the solutions to a debt crisis remain remarkably unchanged–the debt must be repaid by the debtor or it must be forgiven, explicitly or implicitly, by the creditor. The former while ideal is not simple to carry out, while the latter while simple to execute is not ideal.

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References

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2 Alan S. Blinder and Mark Zandi, "How the Great Recession Was Brought to an End", 2010.