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IS AMERICAN DEBT HURTING THE AMERICAN ECONOMY?

by Amelia Preece

The American economy is deep in debt. Corporations, households, and government all face a rising level of debt which is especially unusual for a period of economic growth. The ratio of debt to Gross National Product rose from under 1.4 % in 1980, where it had been since at least 1965, to 1.7 % of GNP in 1985. If a recession occurs, large debts will increase the severity of the recession and limit the ways the government can respond to the recession. Corporate, bank, and household bankruptcies increase dramatically if a recession occurs.

How Deep in Debt Are We? -- The United States has recently become the world's largest debtor nation. We owe 200 billion dollars more to foreign nations and foreign nationals than is owed to us. The federal debt is well over a trillion dollars. Corporate debt is more than 115% of corporate net worth, up from the recession high of slightly over 100%. The debt due for all corporate bankruptcies is almost twice as much as during the recession four years ago. Servicing consumer debt now requires over 30% of disposable income, up from around 25% from 1971 to 1983. This is the largest debt burden since the Second World War.

Effects of Government Debt -- Debt is not necessarily bad. The government can use debt to pay for building the infrastructure -the system of roads, sewers, schools etc which make economic activity feasible and life more pleasant. Such expenditures increase future income and well being more than the cost of repaying debt. However, recent debt has not been spent to promote future growth. The high federal debt is caused by tax cuts and military expansion. Large deficits will likely continue until taxes are increased.

The current debt may have adverse effects on our future standard of living. The high level of debt makes the possibility of a renewed recession increasingly dangerous since debt reduces the economy's and the government's ability to cope with a recession. 14% of government spending, up from 9% in 1980, is required to pay interest on the national debt. As government debt grows and interest rates increase the percentage of government spending which goes solely for debt repayment increases. This makes it more and more costly for the government to increase deficit spending especially during a recession when tax revenues fall. Yet increased deficit spending is needed to end recessions, or to reduce their severity. Through deficit spending, the government can stimulate demand for goods and services - putting people back to work and companies back in business - and the government can provide emergency assistance for those hardest hit by recession.

The Effects of Corporate Debt -- Corporate debt is benign when used to purchase capital goods, but corporate debt is rising while the value of corporate assets is falling. Debt is not being used to purchase capital. Corporate bankruptcies and the high debt adversely effect workers and unions. Jobs are lost. Contracts are thrown out. Firms deep in debt use layoffs more frequently to reduce their short run costs. New plant and equipment which expands employment or keeps up with changes in technology is not purchased, since firms have difficulty borrowing to purchase equipment when deep in debt.

When corporations obtain funds through bonds rather than stock, the probability of bankruptcy is increased. Interest on bonds must be paid, while the returns to stock can fall when economic conditions are bad. Takeovers, in which some stockholders and corporate managers are bought out (mainly with money raised through issuing expensive junk bonds), increase debt. These corporate takeovers usually do little to improve efficiency and frequently harm workers. Managers may spend their energy in take over bids or in fighting takeovers rather than in improving production. Takeovers increase firms' interest in short term profits at the expense of workers' jobs and health, and the communities in which they exist. Some firms which have been very active in takeovers, like Texas Air, have also been union busters.

Stockholders may or may not benefit from takeover wars. Many stocks are held by workers' pension fund portfolios. If workers lose their jobs, because of a takeover, an increase in the value of the pension fund is a small consolation. No one will benefit if takeovers cause a long run deterioration in the American economy.

Effects of Consumer Debt -- The growing personal debt is perhaps equally troublesome. This growing debt is necessary for the economic recovery. However, dependence on consumer debt for economic growth makes this growth more fragile. Consumption will have to be cut just to prevent bankruptcies. If demand is not growing in other sectors, cuts in consumption will cause an economic downturn.

Banks have been particularly hard hit by the rising number of bankruptcies. More banks have collapsed in 1986 than in any year since the Great Depression. More banks are expected to fail, especially if there is a recession soon. Banks are troubled not only by American debt problems but also by problems of many third world nations which are deep in debt to American banks and may soon default. Many banks have also lent to American agriculture, but the value of the farm land has collapsed.

Reagan Administration Response -- The federal government has been slow at addressing these problems. The Gram-Ruddman bill was designed to reduce the federal deficit. But following Gram-Ruddman may prove impossible, since there are no politically feasible cuts in government spending which will balance the federal deficit. Reducing the deficit requires increasing taxes, which the Reagan administration has refused to do.

The federal government has been even more reluctant to face the problem of corporate debt caused by takeovers. The administration assumes that takeovers increase efficiency. While the administration claims that mergers are competitive, mergers actually lead to less competition. The administration's pro big business stand makes any action unlikely, except prosecution of criminal stock deals.

Some of the American debt has been used to purchase imported consumer goods. We now import much more than we export. This contributes to our foreign debt and reduces the economic growth rate since debt is spent abroad rather than at home. The federal government is finally attempting to come to grips with the trade deficit. The dollar has fallen significantly against other currencies because of looser monetary policy. This lower valued dollar increases the cost of foreign goods, just as a tariff would, and reduces American demand for imports. The federal government has been urging Japan and West Germany to increase their economic growth so that demand for American goods in these nations will increase and the supply of exports to the U.S. will fall as the national demand rises.

Whether this policy succeeds or fails, Americans will still have to pay for the debt mess the Reagan administration caused in its first six years. It remains to be seen if it will have to be paid out of reduced standards of living or whether we can pay for much of it out of increased output and employment from economic growth, if demand for American goods grows in spite of the deteriorating corporate climate caused by corporate debt. If the government plans to retain a free trade policy then it will be necessary to work out economic growth policies with other major industrialized nations. Economic agreement requires that the major developed nations give up some of their independence in economic policies and agree on economic goals and strategies.

In the short run the simplest strategy may be a continued falling dollar, which reduces the price of goods exported from the U.S. This does not require international agreement. However the weak dollar cannot be the whole solution. If the dollar continues to fall the price of imports will rise further and inflation will result. The weak dollar solution also does not address the problem of growing corporate and household debt. One possible solution is economic planning like that used in Japan, where investment and research policies are formulated jointly by government, business, and labor. If the government is to prevent a major recession it is clear that other methods of increasing American investment at home and promoting growth without inflation must be considered.

- Amelia Preece