The Debt Bomb
Only housing is keeping the fuse on America's borrowing habit from burning down
Barron's - January 20, 2003

By Jonathan R. Laing

BUBBLES HAVE LONG BEEN part of the financial firmament. The tulipmania in 17th-century Holland and the notorious South Sea Company stock bubble a century later in England are lowlights of economic lore.

History is replete with numerous other examples of financial manias followed almost ineluctably by huge price busts, down to our own era. Japan is still paying the price of deflation and economic narcolepsy a decade after bubbles in its stock and real-estate markets popped. Debt collapses in Asia and South America punctuated much of the 'Nineties. The bursting of the U.S. tech-stock bubble in early 2000 led to the vanishing of more than $5 trillion in wealth, at least on paper. Now, many worry that a U.S. housing bubble, lofted by four-decade lows in mortgage rates, could explode, eviscerating consumer spending and economic growth.

Curiously, however, one reads almost nothing about what may be the biggest bubble of them all -- the huge ballooning of total debt in the U.S. That measure, an aggregate of the borrowings of all households, businesses and governments (federal, state and local), zoomed up from about $4 trillion at the beginning of 1980 to $31 trillion as of 2002's third quarter, according to the latest available Federal Reserve flow-of-funds data.

While some observers see no cause for alarm in these figures, others fear that this debt surge could be edging the U.S. economy toward the abyss of a bust -- and then into a depression.

Reality Check

The 'Nineties economic boom boosted wage, profit and productivity growth, enhancing the ability of consumers and businesses to service debt. Yet, after-the-fact revelations about the accounting shenanigans of that period lead to an important question: How much of the profit boom and productivity miracle was real?

It may have been as much an artificial product of debt leverage as of true internal growth. Credit-market debt now equals 295% of gross domestic product, compared with 160% in 1980 and less than 150% during much of the 1960s. More ominously, debt as a percentage of GDP exceeds the previous record reading of 264% from early in the Great Depression -- when the aftermath of the Roaring 'Twenties borrowing binge collided with a sharp economic contraction. And today's debt load is clearly starting to pinch consumers and businesses: Credit-card charge-offs of bad loans exceed 7% of total debt outstanding, compared with the previous peak around 5%, reached in the mid-1990s, according to Standard & Poor's.

Engorged With Debt

U.S. personal bankruptcy filings in last year's third quarter jumped some 12% from the level a year earlier. And when 2002's total is in, it will almost certainly eclipse 2001's record 1.43 million.

Meanwhile, mortgage delinquencies are soaring, particularly among less creditworthy borrowers. In the "sub-prime" market, delinquencies have jumped to 8.07% from just 4.50% in 1999, according to Loan Performance, a San Francisco tracking firm. This market, which caters to people with checkered credit histories, accounts for about 10% of the $5.8 trillion of U.S. mortgage debt currently outstanding. Delinquencies on Federal Housing Administration loans, which make up about 15% of the dollar amount of U.S. mortgage debt, are at a 30-year high of 11.8%. The typical FHA borrower is a first-time home buyer with limited funds.

Despite the big home-price jump seen in many regions, soaring mortgage debt and drooping stock prices have severely crimped the net worth of U.S. households. According to the latest Fed numbers, net worth at the end of the third quarter had fallen to just 4.9 times disposable income, about 22% below the 6.3 at the end of 1999.

The corporate debt market has seen huge defaults, too, by such formerly investment-grade behemoths as WorldCom and Global Crossing.

Defaults in the junk-bond market -- which accounts for more than 15% of the $5 trillion non-financial corporate-debt market -- have abated somewhat from early fall, when the 12-month default rate spiked to over 18%. Yet even with the high mortality rate of the weak and the lame to date, the corporate-debt contagion hasn't run its course, warns Moody's chief economist, John Lonski. He contends that the credit cycle can't be deemed to have turned when 88% of his company's latest credit actions were downgrades -- worse than the previous record, 86%, set in 1990 during the Drexel Burnham junk-bond panic.

Slouching Toward Depression?

Ray Dalio, president and chief investment officer of Bridgewater Associates in Greenwich, Conn. -- an outfit that manages around $35 billion in currency and hedge-fund assets -- believes there's a 30% to 40% probability of a U.S. depression over the next two-to-five years.

Dalio notes that, during a recession, interest rates can be lowered to stimulate the economy by making it cheaper for businesses to invest and consumers to buy big-ticket items. Lower interest rates also boost asset prices, by raising the capitalized value of future income streams.

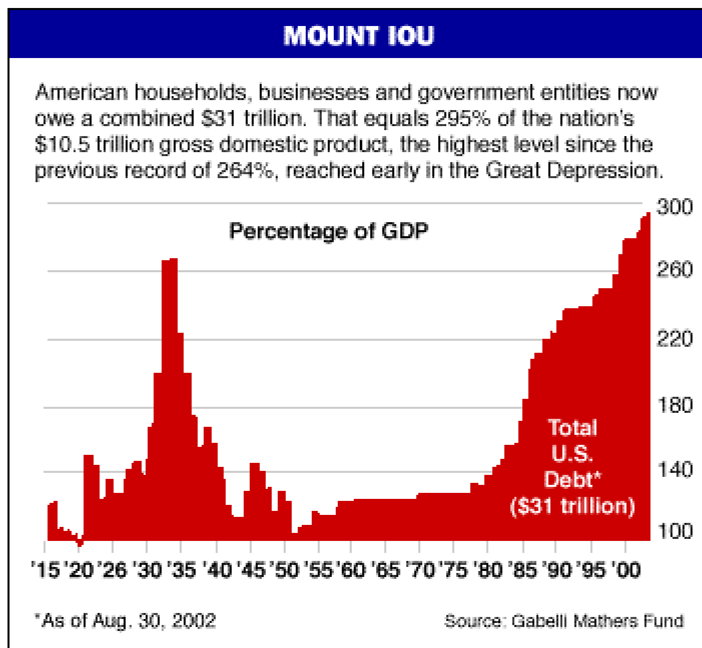
Depressions have a different dynamic. They tend to come after years of debt buildup, when monetary easing no longer works because interest rates are already near zero. Thus, no further debt-service relief is available for overburdened businesses, consumers or governmental units -- especially if deflation causes their incomes to fall. Even if rates hit an irreducible zero, the real burden of debt rises during deflation. Borrowers still have to repay their debts in current dollars while their revenues and collateral fall in value.

In a frenzy to raise cash, debt holders sell assets and cut spending. As a result, the value of the collateral underlying existing debt suffers. Deflationary forces are only exacerbated by businesses cutting prices to stimulate demand in a vain attempt burnish cash flows. In addition, as unemployment rises, consumer demand falls.

The process is not reversible by normal fiscal or monetary stimulation, as seen in the U.S. during the Great Depression and in Japan since the end of 1989, Dalio avers. The Bridgewater executive is quick to say, however, that the U.S. could avoid depression and simply muddle through the next few years.

Still, a number of questions worry him: Why has the bear market been so impervious to two consecutive years of pedal-to-the-metal monetary easing? Normally, stocks would be on fire after such a span. And what will a Fed out of monetary bullets do if unexpected problems in Iraq or another major terror attack on U.S. soil upset the economy further?

Oft-bearish Morgan Stanley economist Stephen Roach also views the U.S. debt load as a serious problem. "There's no question that we have a debt bomb, but I'm not sure how long the fuse will turn out to be," he says. "It won't detonate if the economy remains strong enough to continue to generate enough real consumer-income growth and corporate cash flow to support the debt. Otherwise, we'll experience the darkest scenario of debt deflation, as a result of the worst set of policy mistakes committed by the Fed since the Great Depression."



One of the first economists to delineate the perils of debt bubbles was Yale's Irving Fisher, who wrote the seminal academic article on the subject in 1933, near the depth of the Great Depression. Apropos of his subject, Fisher had been blindsided by the 1929 Stock Market Crash and subsequent economic collapse; he'd argued in a 1929 magazine piece that the U.S. had achieved a "permanent plateau" of prosperity. To make matters worse, he had lost his personal fortune as well as that of his wife's family in the Crash -- and would even have lost his house had Yale not bought it from the mortgage-holders and leased it back to him.

In his 1933 article, Fisher asserted that gross "over-indebtedness" lay behind America's three biggest economic calamities to that time -- the

Panics of 1837 and 1873 and the Crash of 1929. In each, the debt explosions were sparked by technological developments that transformed the economic landscape (canals in 1837, railroads in 1873, autos and radio in 1929), the advent of new industries, the exciting prospects of new lands or markets (e.g., the Homestead Act's opening of the West in the 1870s), or some combination of these factors. The new developments fired investors' imaginations, Fisher contended, encouraging overconfidence -- and greed. Fraudulent claims entice people, too, although there's generally "a very real basis for the 'New Era' psychology before it runs away with its victims," Fisher acidly commented. Sound familiar?

Watching for the Tipping Point

The tipping point, according to Fisher, comes at a time of "general alarm," when borrowers seeking to get liquid or creditors worried about repayment trigger distress selling. Credit availability contracts, as does monetary turnover. Prices tumble. Businesses fail. Output, trade and employment career lower. In short, the psychology of derring-do gives way to pessimism and loss of confidence. Finally, deflation causes money's purchasing power to rise sharply, making debt all the more onerous to repay in both real and nominal terms. This, Fisher observed, "is the chief secret of most, if not all, great depressions: The more the debtors pay, the more they owe. The more the economic boat tips, the more it tends to tip."

Of course, there's no inevitability to depressions. Fisher maintained that if Washington had taken immediate steps to reflate the economy -- to stimulate it by monetary means -- after the 1929 Crash, the corrosive debt deflation that ensued might have been avoided. Instead, the Fed raised rates for a time, choking the supply of money and credit in an attempt to balance the budget. Protectionist trade measures compounded the policy bungles.

More recently, notes Martin Barnes, managing editor of the Montreal-based Bank Credit Analyst newsletter, the Bank of Japan kept raising rates for eight months after that nation's stock market peaked in 1990. By the time the central bankers reversed course, stocks were down some 37% and deflation was building. Years of subsequent cuts that pushed interest rates below 1% still haven't pulled the Japanese out of their funk.

The Fed has only 1.25 percentage points left for cutting short-term rates. In recent speeches, U.S. central bankers have implied their willingness to prime the monetary pump by buying long-dated government and corporate bonds and other assets -- and to drive down the dollar's value by selling greenbacks and purchasing assets denominated in foreign currency. The latter moves would be aimed at stimulating the economy by making U.S. exports more competitive while boosting domestic price levels by making imports more expensive.

Nonetheless, economic policymakers are ill-equipped to fight debt deflation, after having spent two decades battling the opposite evil, inflation. Consequently, they've overlooked certain economic imbalances, which have led to economic crises of increasing gravity and frequency. Among them: Japan's post-1990 slump; the 1997 Asian financial crisis; and the 1998 debt crisis in Russia and certain other developing nations. At least that's the contention of a recent working paper by Claudio Borio and Philip Lowe, economists at the Bank for International Settlements in Switzerland.

Asleep at the Wheel

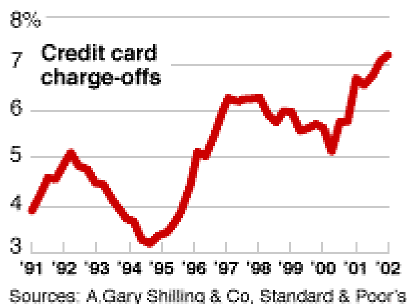
In each case, the authors argue, economic authorities, fired with a monomaniacal zeal to crush inflation, virtually ignored a huge buildup in debt -- the best indicator of a likely crisis -- that created asset-price bubbles. It's ultimately a crash in asset values, be it stocks and real estate in Japan or condos and resort properties in Thailand or Palm Beach, that unleashes the deflationary tidal waves that flatten the workaday economies of goods and services.

First, disinflation (the slowing of increases) in wages and material prices and falling interest rates allow corporate profits to surge. Stocks rise, amplifying consumer demand through the so-called wealth effect. And, the authors assert, the triumph over inflation fosters technological innovation and labor-market liberalization, which make the economic future seem only brighter. Then, belief in unprecedented productivity invariably precedes the fall in asset prices and debt implosions. Finally, policymakers are loath to use monetary policy or other measures to snuff out asset booms, the paper asserts, because such moves aren't politically popular.

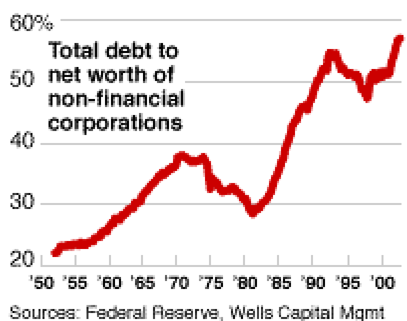
The likelihood of the U.S. falling into a deflationary morass seemed so remote until recent years that commentators such as Elliott Wave guru Robert Prechter, economist and Wall Street-letter publisher A. Gary Shilling and **Wells Capital** economist and investment strategist **Jim Paulsen** were considered kooks for even broaching the subject.

WORRY LINES

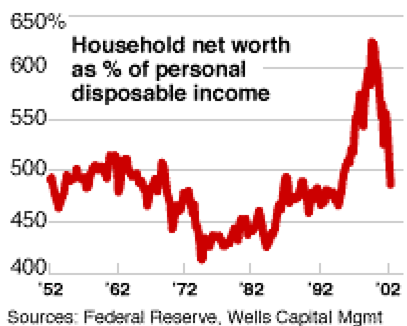
As the percentage of credit-card debt deemed bad has risen, the ratio of borrowings to the net worth of non-financial U.S. businesses has climbed. And a measure of households' financial health--net worth as a percentage of disposable income--has declined.



Sources: A.Gary Shilling & Co, Standard & Poor's



Sources: Federal Reserve, Wells Capital Mgmt



Sources: Federal Reserve, Wells Capital Mgmt

Global Exemplars of Deflation

Japan has experienced four years of falling prices, and Germany is on the brink of deflation. U.S. inflation has dropped to an annualized 1% or 2%, depending on the measure one uses, while U.S. goods' prices have been falling for some months. The annualized rise in service prices, which are less vulnerable to international competitive pressure, has slid to around 3%, the smallest increase in decades.

One obvious agent of worldwide deflation is China, with its reservoir of cheap labor, growing manufacturing might and increased access to global markets by virtue of its recent admission to the World Trade Organization. Ed Yardeni, chief investment strategist of Prudential Securities, recently noted that while the U.S. currently has 16.6 million manufacturing jobs, some 20 million Chinese leave the rural hinterlands each year to seek better-paying manufacturing and construction jobs in their nation's major cities. "China is likely to keep moving up the value chain of production, commoditizing pricing in virtually every low- and high-end product imaginable," he states.

Rising productivity is another deflationary factor. U.S. output per worker-hour has surged 5.7% over the past four quarters, largely as a result of efficiencies realized from corporate cost-cutting and delayed benefits from heavy spending on new technology in the late 'Nineties. Productivity improvements have helped U.S. real incomes to rise smartly from the late 1990s until today, despite an unemployment rate of 6%.

Yet corporations no longer seem to be reaping the benefits of the productivity boom as they did a few years ago, when profit margins and

earnings growth soared. Since then, the same Darwinian price competition that has bolstered consumer purchasing power has hurt corporate revenue and profit growth. "Corporations need to share more in the productivity dividend than they now are [in order] to have a decent recovery," observes **Paulsen** of **Wells Capital**. "Maybe it will take a continued slide in the dollar to help corporate bottom lines. With corporate debt levels where they are now, this is not a healthy situation."

Determining the Detonator

At what level does debt turn lethal? No one knows for sure. Some contend that today's debt level of $31 trillion, or 295% of current GDP of $10.5 trillion, is somewhat artificial. About $10 trillion of the debt consists of the borrowings of financial players -- banks, savings institutions, finance companies, issuers of asset-backed securities and government-sponsored enterprises such as Fannie Mae and Freddie Mac. These entities mostly use their borrowings to fund corporate loans, mortgages, auto loans and credit-card balances. So, in a sense, about a third of today's aggregate debt total is being double-counted. That wasn't true in the early 'Thirties, when the ratio of U.S. debt-to-GDP hit its previous high of 264%, because the financial sector was far less developed at the time.

"I don't think there's any magic level of debt that's too high," says the Bank Credit Analyst's Barnes. "Much of the jump in current debt levels to GDP is a result of the maturation and democratization of the credit system whereby bankers and other lenders now extend credit to groups that were virtually ignored traditionally. We have more people taking on some debt, rather than some people taking on more debt. A bad recession might cause some severe debt problems, but short of that, the worries about debt are exaggerated."

Current government debt -- federal, state and local -- stands at $5 trillion, with Uncle Sam accounting for $3.5 trillion of that. Of course, government borrowing is likely to grow dramatically in the decade ahead as a result of the Bush tax cuts, revenue shortfalls, and the recently announced Bush fiscal-stimulus programs as well as increased spending on homeland and overseas defense. Some congressional estimates suggest a cumulative deficit of as much as $3 trillion over the period.

Fortunately, however, the federal budget stringency of the past decade and spirited economic growth in the late 'Nineties has driven total U.S. governmental debt down to under 50% of total GDP, versus 70% in the early 'Fifties and 65% in the mid-'Nineties. The U.S. has a long way to go before governmental debt proves damaging by "crowding out" private credit demand and boosting interest rates. Other developed nations have far higher government debt-to-GDP figures; Japan's is about 150% yet its 10-year government bond yields less than 1%.

Meanwhile, the non-financial corporate-debt market, accounting for $4.9 trillion of the U.S. debt total, has been a charnel house for investors over the past two years. Defaults have skyrocketed, particularly in the wholesale electric- power, telecom and high-tech sectors. A staggering 18.4% of all speculative-grade debt, on a dollar-weighted basis, went into default in the 12 months ended last Aug. 31, Moody's says. Default rates have shrunk some since then, as have the gaps in yields between junk and government bonds. Yet Moody's Lonski says the yield gap is still at an elevated level of nearly eight percentage points.

Finally, Lonski points out that corporate revenues, the raw material of debt service, have fallen to just 113% of corporate debt levels -- the second worst reading in debt-repayment capacity since the Great Depression. "That revenue-to-debt ratio should be a lot higher -- it ran 130% to 145% in the mid-'Nineties -- for companies to generate sufficient cash flow to handle their debt and maintain the value of the collateral backing their debt," he asserts.

One saving grace: Corporate credit growth has slowed to a crawl of late (it was up 1.8% in the third quarter), as companies strive to use internal cash flow to deleverage their balance sheets.

If the Housing Bubble Blows...

If the U.S. debt bomb ever explodes, the detonator probably will be the residential mortgage market. Home loans account for $5.8 trillion, or nearly 70%, of the U.S.'s $8.2 billion in household debt. Academic studies show that changes in home prices have nearly double the impact on consumer spending than does the "wealth effect" from rising or falling stock prices. After all, stock ownership is more concentrated in higher-income groups, and nearly 70% of U.S. households own a home.

And home prices have been on a tear, rising nearly 50% nationwide over the past six years, bolstered by falling interest rates and looser credit standards. Consumers have tapped this surging equity value through wave after wave of cash-out mortgage refinancings, transforming homes into ATMs. Refinancings have totaled $2.5 trillion over the past two years. In addition, Americans' home-equity loans stand at around $800 billion.

At the same time, Americans' equity in their homes, net of debt, has dwindled to 57%, compared with 85% a half-century ago, even with the recent powerful surge in home prices. Economist Gary Shilling calculates that 39% of U.S. homes are owned free and clear -- and that the remaining homeowners have debt burdens exceeding 80% of the value of their homes. In other words, many Americans have little margin of safety should home prices level off or should they fall as much as 20%, as they did in many overheated areas in the late 'Eighties.

Alan Greenspan and others assert that there's no housing bubble and see no reason why prices shouldn't continue to rise, if at a less torrid pace. Yet Goldman Sachs economist Jan Hatzius sees potential trouble for consumer spending, even if house prices and mortgage rates merely stabilize at current levels. Under such a scenario, refinancing volume is likely to drop markedly, simply because nearly everyone who wants to refinance has already done so.

Hatzius estimates that, in last year's third quarter, on an annualized basis, Americans sucked out $320 billion more in equity from their homes than they reinvested in real estate. This dwarfs the $60 billion in additional outlays the White House says its fiscal-stimulus plan could generate this year.

Some of the $320 billion may have flowed into other investments or into savings. But Hatzius thinks that most equity withdrawals went into

consumption, given the still-limp consumer-savings rate (now 4%, compared with more than 8% in the 'Sixties) and poor performance of the stock market. With refinancings slowing, the Goldman economist sees consumer spending rising only 2% or less this year.

By his reckoning, home values are at record levels, compared with either rents or median household incomes. Hatzius worries that housing is now highly vulnerable, owing to the likelihood of higher interest rates, rising unemployment and lower home prices. And if the housing bubble bursts, instead of gently deflating, the nation's economy could be in for a major meltdown. In essence, then, the American home is a bulwark for the economy. As long as housing values stay high, the nation is sheltered from a detonation of the debt bomb.

E-mail comments to editors@barrons.com1

Copyright © 2003 Dow Jones & Company, Inc. All Rights Reserved.