Debt

John Lunn[1]
Hope College

and

Martha LaBarge[1]
Hope College

Μηδενὶ μηδὲν ὀφείλετε εἰ μὴ τὸ ἀλλήλους ἀγαπᾶν[2] (Rom 13:8 BGT)

The recession that began in 2007 was precipitated by a financial crisis. Almost by definition, a financial crisis is related to debt. In their study of financial crises over the last eight centuries, Reinhart and Rogoff (2009) summarize their results, "If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, whether it be by the government, banks, corporations, or consumers, often poses greater systemic risk than it seems during a boom" (p. xxv). The crisis involved private debt, but that soon turned into public debt, a common occurrence after a financial crisis (Reinhart and Rogoff, 2011).

1. Debt in the United States

Prior to the Great Depression, government debt was relatively trivial, increasing mostly during times of war. Consumer debt was undergoing a transformation as people began buying durable goods on time. Mortgage debt was relatively small. Homeownership rates in the United States hovered a little above 45 percent through the first quarter of the last century. Mortgages were characterized by short time lengths (five to ten years), large down payments (50 percent or more), and no amortization of principal. Homeowners were forced to refinance every five or ten years, even if the interest rate had increased. Most of the risk associated with a mortgage was borne by the homeowner.

Mortgages changed with the establishment of the Federal Housing Administration in 1934. In an early example of financial engineering, the FHA created the thirty-year, fixed interest rate mortgage, with amortization of the principal over the life of the loan. Over time, these developed into mortgages with low or no prepayment penalty and the government allowed mortgage interest to be deducted from taxable income.[3] The result is that the interest rate risk associated with mortgages switched from homeowners to banks. After World War II, homeownership rates rose rapidly to the low 60 percent range by the late 1950s, and ranged between 62 and 65 percent from the early 1960s to the early 1990s.

Household debt increased rapidly in the postwar period. Americans had become accustomed to taking on more debt when the payments could be spread out over time since before the Great Depression, and this continued as Americans began moving into suburban homes. A new type of debt became popular as well—credit card debt.

In early 1952, debt of households and nonprofit organizations amounted to 23 percent of GDP. A decade later the percentage increased to 39.5 percent but grew more slowly over the next decade to 41.2 percent. Ten years later, it had increased to 46.3 percent, then to 59.2 percent in 1992 and 71.6 percent in 2002. Just prior to the recession in late 2007, debt was 95 percent of GDP.

2. Debt and the Recession

The popular narrative regarding the financial crisis is that it was due to greed on the part of Wall Street and bankers, who created confusing and perhaps fraudulent financial instruments to get unsuspecting households to buy houses they couldn't afford. A bubble in housing prices developed, fueled by increasing debt, making many households vulnerable in case of a collapse of home prices. The collapse came, with the result that many households had mortgage debt exceeding the value of their house. The financial crisis spread to the real economy, causing sharp increases in unemployment and decreased output.

Gary Gorton (2010) offers a different perspective. Subprime mortgages originally were created to serve potential borrowers without money for a down payment and whose credit rating was not high. These people were riskier but often had jobs and were paying rent. How could banks provide mortgages to them? What assets did they have? A house would be an asset whose value could increase over time. This group of potential customers were riskier so the bank wanted certain precautions, and did not want to offer a typical thirty-year, fixed rate mortgage in which the bank bears the interest rate risk. The solution was to develop a mortgage that encouraged the borrower to refinance after two or three years. The key features of the mortgages were a short-term period of low interest rates and the ability to refinance at better terms as the value of the home increased. Gorton claims, "Between 1998 and 2006, subprime mortgages worked as they were supposed to" (p. 81). The success led to increasing the number of subprime mortgages and mortgage originators paid less attention to the credit-worthiness of a homebuyer. Further, many households refinanced the new market value of the home instead of the original amount of the loan. That is, the value of the house increased but was used to finance purchases of other goods.

The design of subprime residential mortgage-backed securities also created problems. Two factors affected the risk of the assets—the risk of the underlying mortgages and the risk from the way the securitized assets were put together. These assets were very sensitive to changes in house prices, but the prevailing attitude was that house prices could only go higher. Subprime mortgage-backed securities went from about 50 percent of the dollar-value of securitized assets in 2001 to 80 percent in 2006.

Collateralized debt obligations (CDOs) increasingly were made up of subprime bonds. Between 2005 and 2007 the issuance of CDOs related to housing nearly tripled. Banks and other financial institutions owned large quantities of CDOs. When housing prices plunged, often no one knew for sure where specific mortgages were located and where the risk was located. Markets priced these "toxic assets" at prices well below what they had originally sold for. This excessive mortgage debt fed into balance sheet problems for banks as the banks' assets declined in value. Since many of these assets also were used as collateral in the shadow banking market, severe ramifications followed. Gorton (2010) also goes into the shadow banking system that had developed and was used by large corporations to meet short-term debt needs. As Gorton notes, there was a panic in the shadow banking system, or, what he calls "the panic of 2007."

Another feature of the banking system at the time was the practice of banks placing assets off their balance sheets. These items represented risks undertaken by financial institutions which misrepresented the bank's solvency. Many of these assets were derivatives and were valued at a net settlement amount. These securities were kept in separate entities such as Structured Investment Vehicles (SIVs) and Variable Interest Entities (VIEs). Reporting this net amount in financial statements allowed banks to hide risk. Off-balance-sheet assets allowed financial institutions to appear better capitalized than they were, thus meeting capital regulatory requirements and masking the true leverage of the firm. Regulators and investors could only guess at banks' exposure to the subprime mortgage market because these items weren't included on their books.

It is estimated that $4 trillion in assets are erased by banks netting of derivatives and $3 trillion are removed from books in mortgage securities.

These amounts would nearly double the assets of three of the largest U.S. banks.

So, the relationship between debt and the financial crisis is more complicated than the popular ideas. Household debt grew too large too fast, financed primarily by rising mortgage debt. The mortgage debt was packaged in complex financial assets that made it difficult to know the value of the assets once default rates on mortgages grew. Banks and other financial institution held huge amounts of these assets, often off their balance sheets, which caused them to have balance sheet problems once weaknesses in the housing market became apparent. Involved in all this was the shadow banking system. When the assets used as collateral became suspect, there was a run on the bank and it was possible that some large corporations could have difficulties meeting their short-term obligations, or even a payroll.

3. From Private to Public Debt

Households, corporations, and most financial institutions are in better shape today than they were just before the financial crisis. But the crisis led to a recession and the federal government responded to the recession with an increase in debt-financed government spending. This, combined with reduced tax revenues due to the recession, generated large increases in government debt. The federal debt has increased to almost 100 percent of GDP—a level that we surpassed only towards the end of World War II. Further, there are no signs that the deficit will shrink any time soon, so we expect the federal debt to continue to increase.

The total federal public debt stood at $6.8 trillion a decade ago and was $16.7 trillion as of the end of the third quarter in 2013. Roughly 75 percent of that increase occurred after the start of the recession. As a percent of GDP, the debt increased from 64.3 percent at the end of 2007 to 99 percent at the end of the third quarter in 2013. Since the start of the recession, household debt fell roughly $1 trillion and federal government debt increased $7.6 trillion. The American Recovery and Reinvestment Act passed in January 2009 was a $787 billion stimulus plan, with spending spread out over several years. Clearly, the stimulus plan is not the only reason the federal deficit increased so sharply.

It is easy to see how private debt can be excessive, but what about government debt? Prior to the Great Depression, the public consensus was that government debt should be avoided. It can be argued that the severity of the depression along with Keynes' analysis of the problems and solutions completely reversed that consensus. The current debate is between those who think debt is not an issue at all and that the government should do everything it can to keep unemployment low, and those who think we should seek to balance the budget over the business cycle.

Buchanan (1958) counters the Keynesian argument that the creation of public debt does not involve any transfer of the real burden of the debt to future generations. Buchanan and Wagner (1977) argue that the long-term political legacy of Keynes is persistent government deficits. Keynes removed the stigma of federal debt and his followers sought to stabilize an inherently unstable market economy. Buchanan and Wagner argue that with the stigma of debt removed, the public began seeing the "price" of government programs to be less, stimulating an increase in quantity demanded for government programs. They write, "The juxtaposition of Keynesian policy prescriptions and political democracy creates an unstable mixture. The economic order seems to become more, rather than less, fragile—coming to resemble a house of cards" (Buchanan and Wagner, p. 76).

Trouble in the housing market was a major factor in the severity of the last recession. It turns out, though, that housing is always a key factor in recessions in the United States. Leamer (2007) examines all the recessions since World War II, and finds that housing leads the way down, with an impact on recessions greater than one might think given its size in the U.S. economy. In part, this is because housing declines generally are shortly followed by declines in consumer durable purchases, causing increased unemployment in both construction and manufacturing. The decline in housing was greater in the last recession than other post-war recessions, partly because the boom in housing in the years leading up to the recession was so great. Since so many more homes were built than normal, once the housing market collapsed low-interest policies of the Fed had little effect. Leamer (2007) summarizes the link between the Fed and housing by stating, "*The Fed can stimulate now, or later, but not both*" (p. 151, emphasis in the original).[4]

4. "Owe No One Anything, Except to Love Each Other"

The Bible's attitude toward debt is very negative, and this negative view persisted in the Church for most of its history. Debt often forced people into slavery in Israel and throughout the Mediterranean area in the time of Paul. There are some Christians today who argue that, based on Romans 13:8 and other passages, Christians should avoid all debt. While we are not in agreement with that because the modern industrial and market economy differs so from the agrarian economy of biblical times, the Great Recession is a reminder that debt can be dangerous. Perhaps it is a reminder that the virtue of prudence is an important virtue in a market economy.

Traditionally, the "proper" use of debt was for expenditures that involved durable goods, especially investment goods. Households would take mortgages on homes, and maybe use credit to finance the purchases of consumer durables such as major appliances and automobiles. The flow of services from these goods persisted over relatively long time periods. Similarly, debt for businesses was seen as prudent when used to finance capital expenditures. For the government, the concomitant idea was to use debt for projects that would benefit multiple generations, with taxes used over time to pay off the debt. In this way, all the beneficiaries of the program would contribute to the financing of the program through taxes.

The changed attitude toward public debt is the result of Keynes and his work. Robert Skidelsky (1976) attributes the changed attitude in Keynes to a "…changed attitude to life dating from his days in Cambridge and London in the 1900s" (p. 14). This new attitude was shared with many of his friends in the Bloomsbury Group. The changed attitude was one that believed life was to be lived for the present.[5] This view threw out the Victorian view of Puritan values such as calling, a work ethic, and saving. Skidelsky attributes this change in attitude to be the reason much of Keynes' work amounts to an assault on saving. Skildesky notes,

> Goethe's famous lines sum up the aesthetic credo: "Then to the passing moment I would say, Thou art so beautiful, Wilt thou not stay?" Keynes could not match the poetry of this in his equally famous remark, "In the long run we are all dead." But its spirit is the same—which is that we need a system of economics to enable us to enjoy life now, not in the future when we shall be dead (p. 15).

John Wesley advised his followers to "Make all you can. Save all you can. Give all you can." Keynes' advice would be to "Consume all you can," or perhaps, "Eat, drink, and be merry, for tomorrow we die."

5. Lessons Learned

The most important lesson we have learned from the Great Recession and its aftermath is that debt matters. Further, debt can be like alcohol or drugs—the euphoric feeling from the boom financed by debt clouds our judgment as to when debt has become excessive. Households and corporations have worked to improve their balance sheets, but this is not true for the federal government. There remains a debate in economics as to whether public debt can become a problem or not. We think it can be a problem, especially if the debt reflects an attitude that the present is all that matters combined with a citizenry that appears to want more government services than they are willing to pay for with taxes.

Endnotes

1 John Lunn is the Robert W. Haack Professor of Economics at Hope College; *lunn@hope.edu*. Martha LaBarge is Associate Professor of Accounting at Hope College; *labarge@hope.edu*.
2 "Owe no one anything except to love one another."
3 The United States is the only major nation with mortgages containing all these provisions.
4 Gjerstad and Smith (2014) also connect housing debt to the recent financial crisis and recession.
5 Keynes cited G. E. Moore's *Principia Ethica* as fundamental to his group shortly after publishing his own *General Theory* (Skidelsky, p. 15).

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