CONTINUING DISCUSSION ON DEBT AND SPENDING

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Following on from my August notes on "Debt and Spending" where I raised concerns about the level of household debt, I had an extended discussion with a hedge fund colleague. This manager voiced the following query:

> *Your concern over this trend* [rising household debt as percent of income] *basically argues that at some point twenty or so years ago the number was right, and now it is excessive. Is that true? I am wondering, what is the optimal capital structure of the average U.S. household with respect to income? From 1982 to 1999 wealth as measured by stocks grew 12X (it's also 12X from 1982 to today), but we know real income didn't grow that much. Even with bonds and housing growing far less in that period, there's little doubt real wealth moved up quite smartly. Yet, in your chart the percentage of debt with respect to income went from 60% to 90%.*
>
> *If a corporation's book value grew by ten times while its income doubled, would we necessarily say an increasing debt burden with respect to income is a bad thing? Would a private equity guy step up and relever the company? Is it possible that we've got some old fashioned Friedman permanent income hypothesis type behavior going on here where we increase consumption and borrowing with a very significant lag based on not just realized income, but also wealth (material and human)? That could explain why consumption didn't fall with the stock market correction from 2000-2002, or might not fall with a major real estate reversal.*

In general the manager was upbeat on the economy relative to most people. He thinks "we are in one of the great transition periods in history similar to when England passed the economic baton to the U.S. a hundred years ago." I agree with his optimistic view in the long-term, as I lay out below, but in the short-term I believe there will be difficulties.

To address the specific questions, I think the manager is right to question whether some point twenty years ago was the "right" number for debt. I hope I'm arguing not so much that twenty years ago was right (or wrong), but that the recent increase in debt seems fast relative to income, asset and net worth, and the behavior of spending vs. income.

Figure 1 below is my original graph showing debt (relative to income) growing faster since roughly 2000 than at any time since the mid-1960s. This may not be a problem. I think increases in productivity (technological improvements, freer trade) raised potential GDP growth in the US and world since the mid-1990s. Consumers should rationally respond by increasing current spending relative to current income in expectation of higher future income. (A la Friedman permanent income.) Consumers should increase debt. The real question is the size of

future growth relative to the rise in current spending, and thus whether current debt is "too much". My hypothesis is that increases in productivity have been over-estimated relative to the rise in current spending, and that current spending financed through higher debt will turn out to be misplaced. Not wrong, just somewhat too high, requiring some downward adjustment before growth can resume.

The manager points our, correctly, that assets have grown dramatically since the 1980s. So maybe high debt isn't so much of a problem. Here's growth since 1982:

growth to	1999	2007
Equities	12.3x	10.9x
Assets (tangible + financial)	3.9x	5.7x
Net Worth	3.9x	5.3x

(this is all from the Fed's Flow of Funds, and is for Household + Non-profit. They don't split household out separately but it seems non-profit doesn't change too dramatically as % of total.)

But debt still grew substantially faster than total assets as can be seen in figure 2. (I think total assets is probably more relevant than equity assets alone). Debt relative to total assets or net worth is much higher than it's ever been – see figure 3 below. Again, this may not be a problem since with increases in wealth and financial sophistication over the past few decades I might expect the "optimal" level of household debt to increase. But I still have a gut feeling that debt has grown faster than it should have. (It does not comfort me that the only times recently when debt/NW has fallen or been level has been the run-up in the stock-market in the 1990s and the recent house-price inflation.) To me it comes back to income relative to spending. During the 1950s and early 1960s debt grew as fast as during the 2000s (figure 4 shows things on log scale which makes easier comparison of 1950s and 2000s.) But during the 1950s spending was a much lower percent of income.

In the end, I think debt is just somewhat too high and debt or spending will adjust down. I guess part of my belief (and I'm not sure it's perfectly rational) is tied to my view that we are in a "New Economy" relative to the 1970s and 1980s, but that part of the new economy brings risks of periodic financial crises, particularly tied to credit, liquidity, and debt.

Back in the late 1990s there was much discussion of the "New Economy" and although the term isn't used much now in many ways it was right. I think the new economy is both a big change from the recent past but also a reversion to an earlier, classical, model of capitalism

Some characteristics of the new economy

- Large investments in new productive opportunities
- Productivity-led or supply-led growth exploiting new opportunities and new technologies
- Substantial economic growth without signs of inflation
- Massive wealth creation and rising incomes
- BUT Cycle often ends with financial “crisis”

This differs in many respects from the post World War II Keynesian or "demand-led" economy, characterised by

- Excess demand, limited supply
- More aggressive government intervention through monetary and fiscal policy
- Inflation associated with periods of growth
- Cycle often ends as Federal Reserve raises rates to choke off inflation

Why is this new paradigm "Classical"?

- This New Economy or supply-led paradigm showed up frequently during the 1800s and early 1900s
- The pattern seemed to die out after the Great Depression of the 1930s

But there are Risks - Speculative Boom and Bust

- In many cases supply-led growth was followed by speculative boom and bust
- A period of supply-led growth does not necessarily turn to speculative boom and bust - various conditions (displacement, monetary expansion, appetite for speculation) must be present. But it often did. My fear is that it may have now. (No doubt readers will recognise that I've taken much of this from Kindleberger's Manias, Panics, and Crashes)

I think potential growth has gone up. Consumers rationally increased current spending and debt during the 1990s and 2000s. I just think we have all somewhat over-estimated potential growth and consequently debt is somewhat too high. One might call this a speculative boom but I think it may be part of how this "New Economy" works - there is uncertainty and potential for miss-estimation in one direction or another. The result may be a financial crisis or a bust. But with a lender of last resort (central banks as we know them were not around in the 1800s) the crises will probably be substantially diminished.

In the end, as you say, we'll get relevant data on consumer spending soon. I'm watching retail sales and spending to see whether there's any pull-back. But any short-term issues do not reverse or negate the more optimistic long-term outlook.

Figure 1

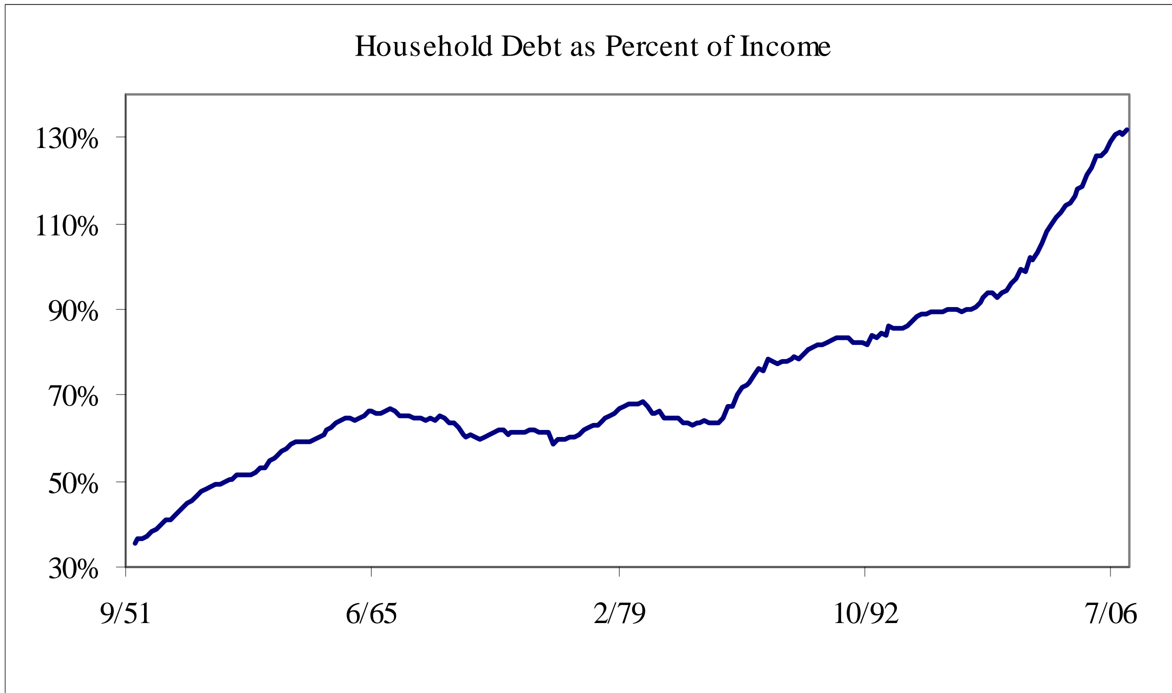

Figure 2

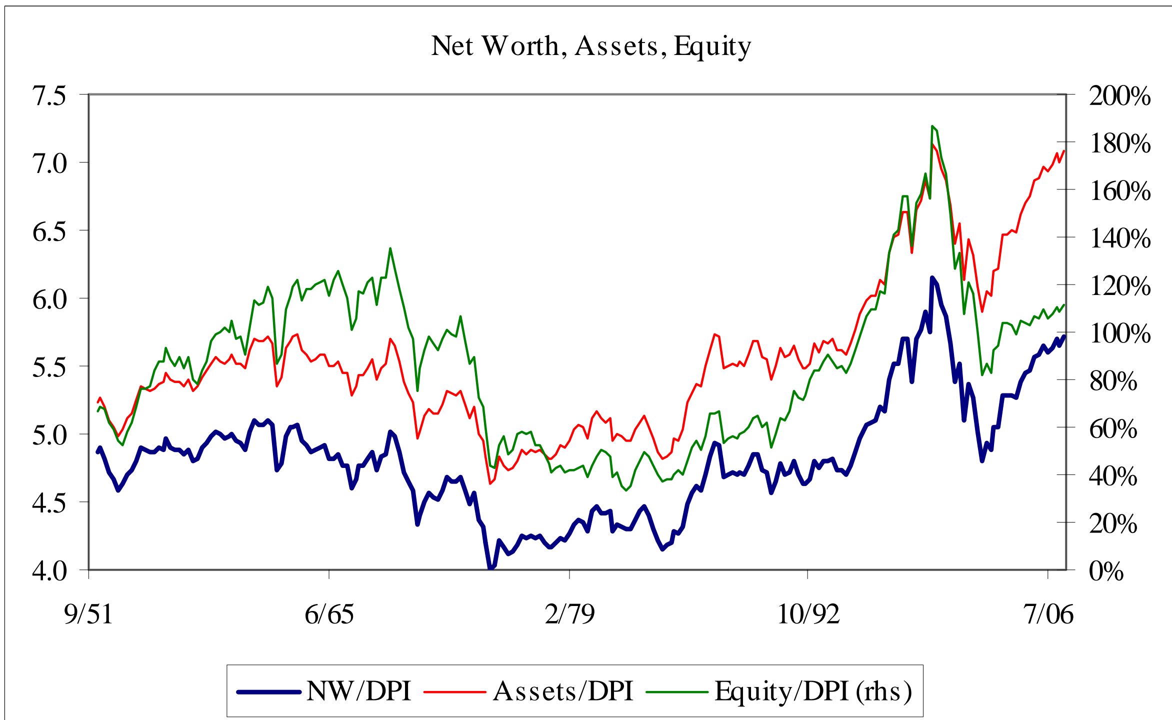

Figure 3

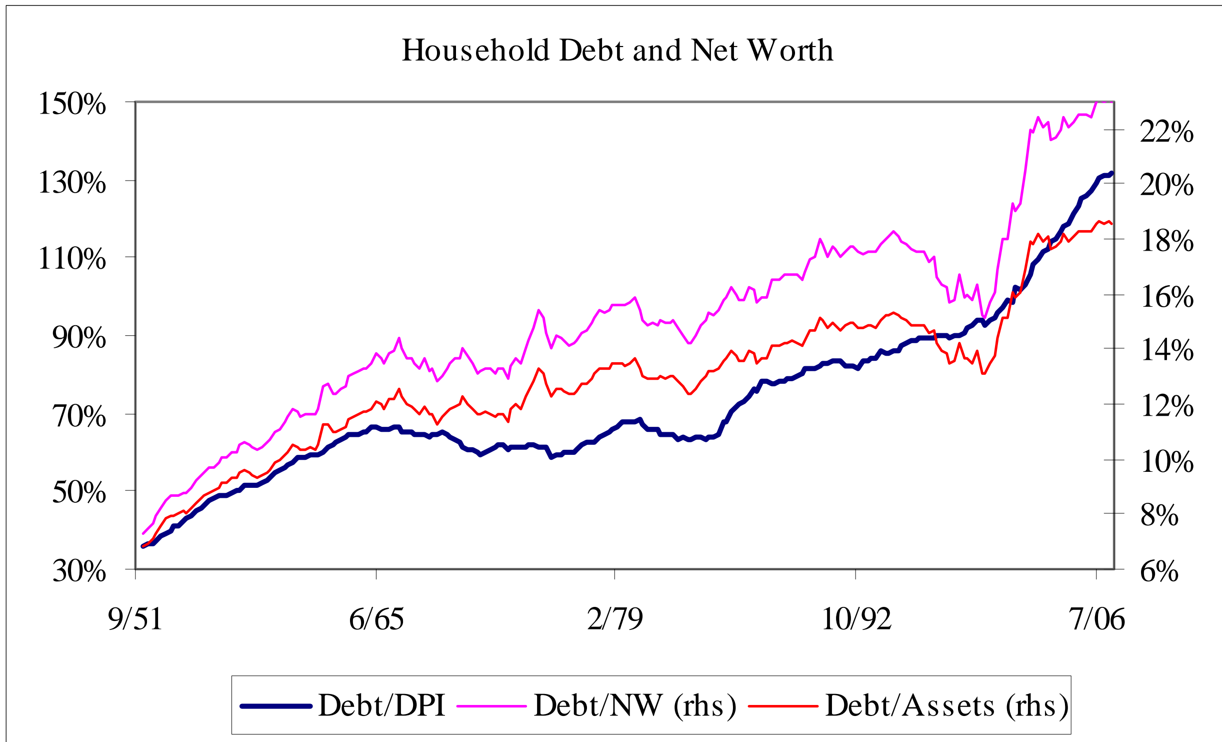

Figure 4

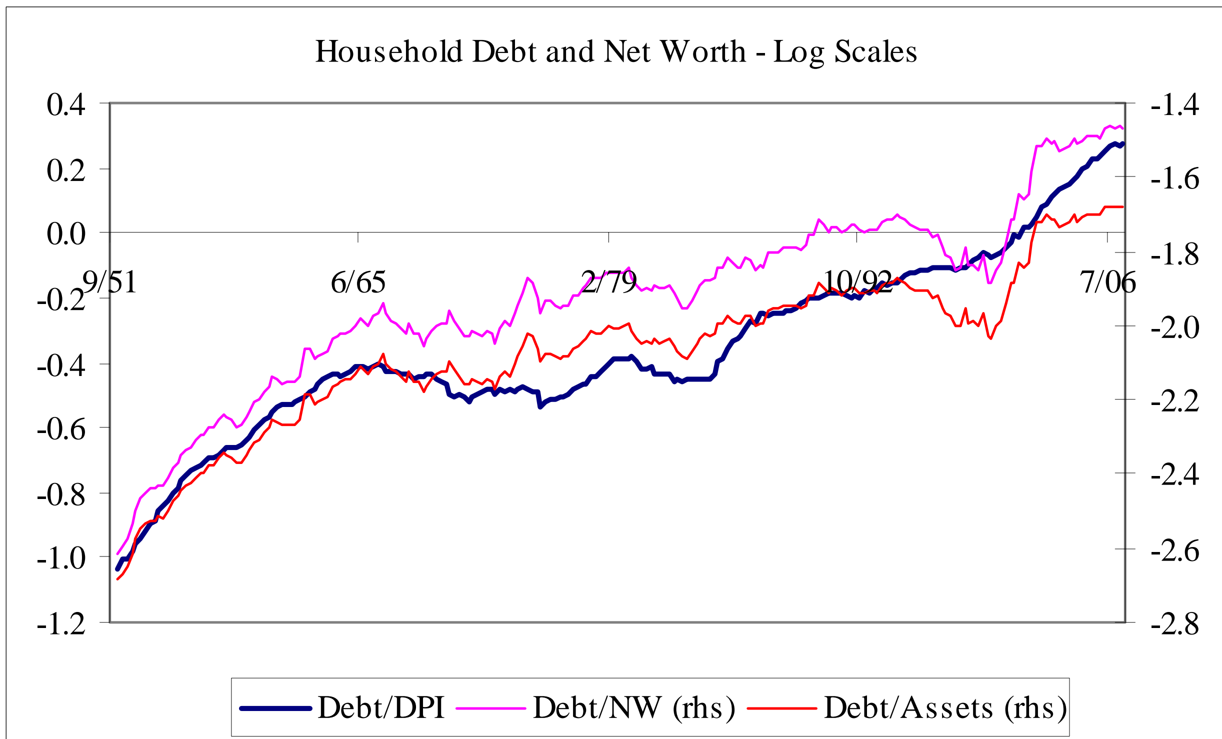

Figure 5