PERSPECTIVE

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AMERICA'S DEBT WOES

America is struggling with a public and a private debt problem. Make no mistake, debt can be beneficial when used productively and accumulated in moderation. However, like most things in life, excess has consequences. Debt can turn toxic when unproductive or overindulged. The financial crisis and ensuing Great Recession show this to be true.

The root of America's current woes was a credit bubble, manifested in massive accumulation of household debt tied particularly to real estate. When the overvalued real estate market suffered a deep correction, the economy sank, personal financial strains became acute and the financial system almost failed. This calamity set off a deleveraging of household finances and the financial system went through a painful process of restructuring its balance sheet to restore solvency.

Policymakers were forced to respond. They realized that a rapid unwinding of the personal debt and financial system imbalances could lead to a depression. Accordingly, vast monetary and fiscal stimulus was deployed to limit the depth of the downturn. The magnitude of the stimulus was enormous, with the federal government running massive deficits.

The policy actions had the desired effect of tempering the depth of the economic contraction. However, the stimulus was not adequate to foster a strong economic recovery. Put simply, policymakers prevented the worst case scenario, but they also extended the time frame over which imbalances would be unwound. Consumers still needed to deleverage, resulting in an extended period of weak private demand, in spite of a hyper-low interest rate environment. Moreover, the tsunami of foreclosures led to persistent weakness in real estate. Traditionally, real estate is one of the first sectors to fall into a recession, but it is also one of the first sectors to recover. This time, due the unprecedented overhang from foreclosures, real estate was the first in, but the last out. Since homes are the single-biggest asset for most households, the long-lasting weakness in real estate reduced personal wealth, lowered consumer confidence and constrained spending.

A deleveraging of household finances has taken place. Personal debt as a share of personal disposable income has fallen from a peak of 129 percent in mid-2007 to 108 percent at the moment. The challenge is that there is no explicit golden-ratio, so one does not know to what extent consumer deleveraging still needs to continue. Factors like debt service costs affect the willingness and ability to carry debt. The current low-rate environment is keeping debt affordable. Higher rates in the future could require more deleveraging.

The distribution of the debt matters as well. Consider that the overall ratio is equivalent to having a household with $100k annual after tax income and a mortgage of $108k. Would you view that household as being in dire financial conditions? The answer is no. Some households are dramatically below the average, some dramatically above the average – we worry about latter. The composition of debt is also important. Large amounts of sub-prime debt are far more worrying than equivalent amounts of prime debt.

The implication here is that there is no clear line in the sand on where excessive personal debt

exists. However, the ratio does tell you something about the overall extent of leverage; and, even with the recent decline, household debt is still very high by historical standards. Debt-to-income has only returned to its level in 2003, which was a historical peak at the time. One thing we can say for certain is that debt-financed consumer spending cannot be a major engine of economic recovery.

It is also worth highlighting that many households are still in a precarious financial situation. The share of seriously delinquent loans has fallen from 9.7 percent at the end of 2009 to 6.8 percent at the end of 2012, but that is still twice the pre-crisis level. The number of properties entering foreclosure has fallen, but the rate remains high. More than a fifth of the households with a mortgage are in negative equity – close to 11 million homes. Another 2.3 million are near-negative equity. So, there is still a considerable hangover from the collapse in the housing market that is hampering the economic recovery.

If private debt is still a problem, where will future economic growth come from? It will certainly not be from government. While America had a problem of inadequate saving by households before the financial crisis, the policy actions taken to avoid a depression have now led to an inadequate saving problem on the part of the federal government. America does not face a government debt crisis today, as net debt-to-GDP is only slightly above 70%. The real problem is where government finances might be headed. The latest Congressional Budget Office (CBO) projections show that maintaining current policy will lead debt-to-GDP to rise to 90 percent by 2023 and 199 percent by 2037. The message is clear: the government needs to rebalance its finances over the medium term, but in a way that does not jeopardize the economic recovery.

This leads to the issue of how the private and public debt challenges can be addressed. There is a finite set of options. First, you can grow your income to make the past debt less of a financial burden. For governments, this can be achieved by faster economic growth, or alternatively higher inflation, both of which would reduce the financial burden. For individuals, it means securing better employment or higher compensation. Second, you can spend less, save more, and pay down the debt. This is austerity by governments and belt-tightening by households. Third, you can default on the debt. This can be done in a soft or hard way. The former would include restructuring of the debt, while the latter would be an outright default of not honoring any portion of the debt obligation.

The choice of how debt is addressed will shape future economic conditions. The best approach is a gradual and balanced one. Default in any form is simply not an option for the American government, so the optimal path is a combination of stronger income growth and measured austerity. This means implementing economic growth-enhancing strategies. For example, monetary policy can focus on lowering unemployment while fiscal policy can be aimed at investment in infrastructure and incentives for business-sector growth. Deficits must be trimmed, but raising taxes, cutting discretionary spending and reducing entitlements act to depress economic growth. History tells economists that a ratio of 70-80 percent spending cuts to 20-30 percent additional revenues is the preferred mix.

The emphasis should be on fiscal rebalancing over the medium term. The International Monetary Fund (IMF) released a report in January highlighting that economic forecasters generally underestimated the impact of austerity in Europe in terms of dampening economic growth and in raising unemployment. The implication is that fiscal multipliers on economic activity are much higher than previously thought and this could reflect the impact of fiscal tightening at a time when private demand is soft and when the financial system is fragile. This does not mean that fiscal rebalancing in America should not be pursued; but, it does suggest that it should be done gradually over a number of years.

For households, there is limited influence over income. In the elevated unemployment environ-

ment, it is evident that increased skills training and mobility could open the door to better labor market prospects. There is more control over saving decisions, but basic needs will always be a constraint on the extent of purse-tightening. Increased saving by households can reduce leverage, but it also lowers personal expenditure, in turn, acting as a headwind for economic growth -- the paradox of thrift. The remaining option is for private debt to be restructured or outright defaulted upon.

There is a growing body of research that demonstrates that in the wake of an asset bubble and deep price correction a writedown or restructuring of liabilities is called for. Indeed, one could argue that more of the government stimulus program immediately in the wake of the financial crisis should have been directed at addressing the root problem in the mortgage market. And, while there has been considerable deleveraging in recent years, in large part through foreclosures, there could still be benefits today from further restructuring of personal liabilities. However, this would have to be done carefully. It is important to stress than one group's liability is another's asset.

Restructuring or default on personal debt will lead to losses in the financial system, with its own set of repercussions. In the wake of the financial crisis and recession, there will be little sympathy for lenders; but, it is critical to appreciate that one cannot have a healthy economy without a well-functioning and capitalized financial system. The only other option is socialization of personal debt, which effectively transfers the financial losses to taxpayers. Such an outcome is politically difficult and all of the options have moral hazard problems, as it leaves an incentive for people to make poor financial choices in the future.

There is no simple solution, but the best option for personal finances would be a stronger economy that generates more employment and higher income, thus supporting consumer spending and debt reduction. The good news is that there are reasons to be hopeful about the future. Monetary stimulus is still being deployed. The flow of credit has improved, making it more likely that low rates will be beneficial. The housing market has stabilized and construction has doubled from its trough. There is a renaissance taking place in manufacturing, a sector that has become dramatically more competitive in recent years. The global economic slowdown will reverse this year – China is already showing signs of a soft-landing – and this should be supportive to U.S. exports. As we continue to navigate around the global risks, and once the path of domestic fiscal policy becomes clearer, there is scope for improved business confidence that could provide a lift to investment and hiring. All of this won't lead to strong economic growth when fiscal policy looks to shave close to 1.2 percentage points off of the gain in real GDP. Nevertheless, economic growth of close to 2 percent this year is achievable, with more strength likely to come in 2014.

The conclusion is that America is still struggling with the legacy of the credit bubble. While some deleveraging has occurred, the level of private debt is still high and household finances are still strained. Moreover, the improvement in private debt levels has been offset by increased public debt. And let's face it, the pain of public sector deleveraging will be borne by the private sector eventually. The government's finances are not at the breaking point, but unsustainable deficits will create a crisis in the future unless the trajectory of debt is changed. Both public and private finances must be rebalanced. However, there is no magic wand that makes the challenges go away. A gradual and balanced approach is the best way forward, even though it leads to an extended period of restrained economic growth. The imbalances were developed over more than a decade, and they will have to be unwound over more than a decade. It's a hard message for people to hear, but a modest economic growth environment is the good outcome – after all, the alternative was a depression.

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