



## The Gold Standard Institute

### Is aggregate debt excessive?

The Obama administration is looking at the wrong ratio

A paper presented at the Santa Colomba Conference on the International Monetary System at the Palazzo Mundell, July 2009.

Antal E. Fekete, San Francisco School of Economics

---

The Obama Administration has raised the ante in combating the recession by increasing the debt of the government to levels that were previously considered unthinkable. It is explaining away the weakening financial structure of the country by saying that aggregate debt has not increased much relative to GDP and is therefore not excessive.

This argument is false to the core. One cannot take comfort in past increases of GDP to justify future increases of debt. The fact is that the increase in debt has been the major motive power behind the increase in GDP and prices. It cannot, therefore, be tested by its own results. The real test is the burden of debt. The economic advisers of president Obama forget that *the GDP and prices may well decline, but the debt remains fixed*. This means that, given the decline, even without further increases in aggregate debt the financial structure will deteriorate. How much more must it then deteriorate when all caution concerning the threat from excessive debt is thrown to the winds!

The argument about stimulating the economy with the proceeds of selling more government debt is equally false. It misrepresents the long-run economic effect of debt on the capacity to produce. If we stimulate the economy beyond its natural level by increasing debt, then we create a capacity that will not be required, and we induce a price and wage level that will not be possible to maintain when the debt spiral ceases. In this way government stimuli create latent pressures for future price, wage, and output declines, increasing the debt burden to a much greater extent than was originally envisaged.

Some people say it does not make any difference whether the money spent has come from debt or equity. This is fallacious because debt creates rigidities that are hard to adapt to declining prices and output. There will be some very unsettling effects. When people are scrambling for liquidity in self-defense, as they do now, debt will make them extra cautious about increasing their spending. This, in turn, makes conditions worse which will then make the debt more burdensome still, etc., creating a snowball effect. In adapting to adverse conditions the greatest enemies are fixed costs, such as interest, depreciation and, above all, debt which is not only hard to refinance but it also limits flexibility. If equity was used instead of excessive debt, then the snowball effect of adjusting to adverse conditions would be far less.

By virtue of pricing power the granting of "cost-of-living adjustments" to labor is easy and logical, provided that the cycle is in its upswing, so things are kept in fair balance. By contrast, reverse adjustments are very hard to make on the downswing. Therefore rigidities and maladjustments accumulate much faster, and they result in a much more precipitate decline as compared to the preceding rise in output.

The Obama administration is looking at the wrong ratio. Instead of the ratio of total GDP to total debt it should watch the ratio of *additional GDP to additional debt*, that is, the amount of GDP contributed by the creation of \$1 in new debt. This ratio shows how effective debt is to make the economy grow *at the margin*, and for this reason it may be called *the marginal productivity of debt*. As long as it is

well above 1, the creation of new debt has an economic justification. It shows that the economy can have a healthy growth. But a falling marginal productivity is a danger sign. It shows that the quality of debt is deteriorating. Should the ratio fall below 1, it is "red alert". The volume of debt is rising faster than the national income. The country is living beyond its means and is consuming capital.

In the worst-case scenario the marginal productivity of debt may fall into negative territory. This means that *the economy is on a collision course with the iceberg of debt*. Not only does more debt add nothing to GDP, in fact it *causes contraction and greater unemployment*. Debt creation must cease at once as a matter of utmost urgency. The condition of the economy can be compared to that of a patient suffering from internal hemorrhaging that must be stopped immediately.

Several observers calculated the marginal productivity of debt tracing it back for the past fifty or sixty years. One of them, Barry B. Bannister of Baltimore published his results on his website ([bbbannister@stifel.com](mailto:bbbannister@stifel.com)). While the calculations of various observers have yielded various results, they all agree that the marginal productivity of debt has been falling and will reach 0 if it has not already done so. The discrepancy is due to the difference in defining net financial debt to avoid double counting. For example, Bannister is netting out all except the first round debt in the derivatives tower and, as a consequence, his calculations predict a further decline in the ratio but it will not become negative before 2015. Others argue that the layers of the derivatives tower are essentially higher levels of debt re-insurance which cannot be netted out because every higher level means the introduction of new risks. Accordingly, their calculations show that zero marginal productivity of debt was reached back in 2007 and since then the ratio has been negative and falling further.

In spite of disagreements and discrepancies, these studies agree that the present crisis is a debt crisis, and any further addition to aggregate debt runs the risk of making the economy contract further. Under these circumstances the Obama administration's economic policy is self-defeating. More debt is poison to the economy. The internal hemorrhage will continue, nay, it will get worse.

The correct policy should allow insolvent firms and banks to be liquidated without interference from the government. There should be a resolute policy to strengthen the capital structure of the remaining firms and banks. It is imperative that the level of aggregate debt be progressively reduced until a marginal productivity of 1 or higher is restored. It follows that the balance sheet of the Federal Reserve banks should be contracted rather than expanded.

Why is a negative marginal productivity of debt a sign of an imminent economic catastrophe? Because it indicates that the economy is literally devouring itself through the consumption of capital. Production is no longer supported by the prerequisite quantity and quality of capital goods. The responsibility for this belongs to the fast-breeder of debt. It may give the economy a sense of euphoria during the upswing of the cycle, but is devastating in a downswing.

In March, while he was the president of the European Union, the Czech prime minister Mirek Topolanek publicly characterized president Obama's plan to spend nearly \$2 trillion to ease the U.S. economy out of its recessionary hole, as "a highway to hell", and he predicted that "it will undermine the stability of the global financial market". While undoubtedly it was an undiplomatic gaffe and a display of extreme impoliteness, the caretaker prime minister did nothing but blurted out unpleasant truths.

It would have been more polite and diplomatic if Mr. Topolanek had couched his comments in the following tenor: "the stimulus plan was made in blissful ignorance of the marginal productivity of debt which is negative and falling. In this situation more debt will only stimulate deflation, economic contraction, unemployment, and it will lead to further weakening of the global financial structure."

June 24, 2009.

References

by the same author, see [www.professorfekete.com](http://www.professorfekete.com)

*Falsifying bank balance sheets*, April 21, 2009

*Marginal productivity of debt*, March 28, 2009

*A critique of the quantity theory of money*, April 15, 2009