Debt and Systemic Risk: The Contribution of Fiscal and Monetary Policy

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The story of the financial crisis will be retold endlessly as one of widespread corruption and incompetence, enabled by a policy agenda fixated on deregulation. But to accept this story, one would have to believe that if the marketplace had been confined to ethical and informed individuals, and if their activities had been carefully scrutinized by diligent regulators, we would have avoided a major financial boom and bust.

While we cannot rule out such a proposition a priori, we can state with overwhelming empirical support that the history of financial crises teaches us either that it is not so or that we are, in any case, incapable of imposing such structures on anything approximating a free society. The historical evidence has been meticulously compiled, filtered, and explicated in Carmen Reinhart and Ken Rogoff's new study *This Time Is Different: Eight Centuries of Financial Folly* (Reinhart and Rogoff 2009).

Excessive Debt

The heart of the problem, in Reinhart and Rogoff's analysis, is "excessive debt accumulation." That such debt accumulation was a feature of the current crisis is beyond doubt. That it pervaded so many sectors of the economy and underpinned so many asset classes

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is also beyond doubt. That its most damaging manifestation, in the real estate market, was fuelled and fêted by policymakers who supported, as a general principle, more regulation as well as those supporting less regulation, is further beyond doubt. Therefore, any sound attempt at reconstituting regulatory structures in the wake of the crisis must focus directly on restraining excessive debt accumulation.

The first and most essential step in such a process should be applying a "do no harm" test on the current structures. That is, rather than simply assuming that excessive debt is the result of individuals and institutions having a natural predilection for debt which must be restrained by government, we need to consider whether government policy is actually encouraging individuals and institutions to take on more debt than they would in the absence of such policy. We do not have to look far to find compelling evidence that it is: fiscal and monetary policies provide plenty.

Fiscal Policy

With regard to fiscal policy, reform of the tax code should be a priority. At the household level, full mortgage interest deductibility gives Americans an enormous incentive to leverage the purchase of larger homes than they need, and home equity loan interest deductibility then gives them the incentive to leverage consumption by reducing equity in their homes and raising their default risk. Although these phenomena are fairly well known, much less discussed are the problems at the level of corporate taxation. A recent cross-country International Monetary Fund study concluded that "the empirical evidence suggests that tax distortions have caused leverage to be substantially higher than it would have been under a neutral tax system," that "taxation significantly affects [corporate] financial structure," and that "corporate-level tax biases favoring debt finance, including in the financial sector, are pervasive, often large—and hard to justify given the potential impact on financial stability" (IMF 2009: 9, 1). According to the Congressional Budget Office (2005), owing to interest tax deductibility and accelerated depreciation for debt-financed investments, U.S. corporations face an astounding 42 percentage point effective tax rate penalty for equity financed investments (36 percent) vis-à-vis debt financed investments (−6 percent). This naturally encourages them to operate at highly elevated levels of leverage, and made them financially vulnerable as borrowing costs soared during the crisis. Financial institutions, of course, have been the worst affected. The IMF study noted that "the high profitability of financial institutions in recent years will have made debt more attractive for them than for many non-financials," and that the development and use of many complex financial instruments "is in part a response to, and shaped by, underlying tax distortions" (IMF 2009: 11, 1).

The famous Modigliani-Miller theorem, otherwise known as the capital structure irrelevance principle, demonstrates that the proportion of debt and equity capital a company uses to finance itself is immaterial—the cost is the same—in the absence of policy distortions that affect the cost of each. If Modigliani-Miller held in reality, banks would be indifferent to the composition of capital adequacy requirements. Instead, the mere suggestion that equity capital should be bolstered evokes apoplexy among bank senior management. Securitization and the originate-to-distribute business model are encouraged by the tax code, as loans added to a bank's books necessitate more tax-disadvantaged equity. Both the Fed and the Treasury have made revival of the securitization markets a top priority; neither has questioned whether fiscal policy made parts of the economic system more vulnerable by encouraging *excessive levels of securitization*.

Monetary Policy

With regard to monetary policy, the unusually long period of negative real U.S. interest rates from 2002 to 2005 is at least prima facie evidence that it was providing a powerful impetus to debt accumulation. John Taylor (2009) provides compelling empirical evidence that it was. But what can we expect going forward?

The Fed still sees the primary job of monetary policy being to stabilize, over the medium term, some measure of price inflation, whether that measure be an index of consumer price inflation, core inflation, or some other. During the 1920s, it was wholesale price inflation. Yet it is critical to recognize that no general price index stabilization scheme has any necessary connection with the meta-theory that a perfect money is "neutral"—that is, that its existence should not affect relative prices, and that it should not cause trade cycles. "All these theories [of the trade cycle]," Hayek argued in 1933, "are based on the idea—quite groundless but hitherto virtually unchallenged—that if only the value of money does not change it ceases to exert a direct and independent influence on the economic system" (Hayek 1966: 107). The most persuasive study backing Hayek's point is a text by Phillips, McManus, and Nelson ([1937] 2007: 175) on the monetary causes of the Great Depression:

> The behavior of the price level from 1922 to 1929 also serves to show the fallaciousness of the cruder form of monetary explanation of the business cycle, as, in the view of the adherents of that theory, depression will not ensue if the price level is stable. And the futility of price level stabilization as a goal of credit policy is evidenced by the fact that the end-result of what was probably the greatest price-stabilization experiment in history proved to be, simply, the greatest and worst depression.

It must be noted that the idea that monetary policy should regulate the credit cycle has in our time been bastardized into the idea that it should "target asset prices," which at any given point in time is subject to the compelling criticism that monetary authorities can know neither which specific asset prices to target nor what the specific target prices should be. Targeting asset prices is a different proposition from controlling metrics of broad credit growth, which certainly affect asset prices (see, e.g., White 2009).

In fact, the famous 1977 amendment to the Federal Reserve Act which directed the board of governors to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" also directed it to "maintain long run growth of monetary and credit aggregates" so as to achieve those goals. After quoting this requirement in a 2006 speech, Fed Chairman Ben Bernanke, a long-time champion of inflation targeting, went on to enumerate the problems of identifying appropriate monetary aggregates to target while not even mentioning credit aggregates (Bernanke 2006).

There has been much discussion in Washington about expanding the market-intervention powers of the Fed to allow it to control systemic risk. The political attractions of directing the Fed to prevent future crises without using monetary policy are obvious. The economy has been buffeted by numerous failures ranging from mortgage intermediaries to credit ratings agencies to credit default swap sellers, and it is much harder to address the specific causes of those failures than just to instruct the Fed to make sure there are no more of them. This "just take care of it" strategy calls to mind a scene from *Beverly Hills Cop* in which Eddie Murphy drives up to a restaurant in a wreck of a car and tells the valet to "park it someplace good this time. All this sh*t happened the last time I parked it here."

The most common argument made in support of expanding the Fed's powers is that it needs new intervention tools in order to support the stability of the financial system. But by this logic, fiscal policy should also be handed to the Fed, as tax and subsidy decisions can clearly have implications for financial stability—as already discussed. But just as the Fed is wholly capable of conducting effective monetary policy taking fiscal policy as an input, it is wholly capable of conducting it while taking bank capital cushions, leverage ratios, and the like as inputs. Given that the Fed has no inherent advantages over many other bodies as a judge of systemic risk (which is different from saying that it has no advantages in gathering information, which can be communicated to others), the importance of systemic stability is not in itself grounds for expanding the Fed's powers.

One important reason for not doing so is that monetary policy can be, and historically in many settings has been, an important source of systemic risk. Yet there is less consensus today on what monetary policy should do going forward than there has been for at least 20 years. Since we cannot rely on the Fed for an independent evaluation of why excessive debt might be accumulating, it would be a mistake to assign it powers to control more levers of economic policy.

Conclusion

Whereas I have focussed on the problems of private debt accumulation, Reinhart and Rogoff (2009) highlight the historic role of public debt as well. The dramatic rise in the U.S. budget deficit has been justified as a necessary temporary expedient to support a flagging economy as the private sector deleverages. But the government has also taken on enormous new contingent liabilities, many of which are likely to turn bad, in its efforts to prop up the debt-dependent bubble sectors, housing, in particular.

More than 90 percent of mortgages are now taxpayer-guaranteed, yet government-controlled Fannie Mae and Freddie Mac want to go even further by guaranteeing the short-term borrowing of smaller mortgage lenders that use the money to create more Fannie- and

Freddie-backed mortgages. The Federal Housing Association's insurance portfolio is expected to balloon from $410 billion today to $1 trillion by the end of 2010. At 50 to 1, FHA's leverage ratio is nearly 4 times higher than it was in 2006, and 1.5 times higher than Bear Stearns's when it collapsed in 2008.

There are no plans circulating in Washington to reverse any of this. Thus, policy-induced systemic risks are likely only to get worse, in spite of the rhetoric in Washington about the urgency of financial reform.

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