The recent surge in debt has raised some concerns among economists, particularly with its implications for the vulnerability of the financial system and the economy. A viable market-oriented financial system depends on a heavy preponderance of prudent decisions of private parties over imprudent decisions. Despite recent efforts to quantify financial risk and to establish precise rules for managing it, prudent management of financial risk remains a matter of judgment. Moreover, recent financial innovations and regulatory changes have altered the financial landscape and may be especially difficult to assess in terms of the implications of accelerated debt growth.

This Economic Commentary provides a perspective for understanding policymakers' concerns about the increasing debt burden, particularly for the implications of such a debt burden for the integrity of the financial system. We examine how this integrity is essential to the well-being of the economy and analyze the important stabilizing role played by deposit insurance and the lender-of-last-resort function of the central bank. We discuss the nature of the incentives created by the financial stabilizers, specifically whether they encourage excessive risk-taking. We also consider the possibly adverse implications of the increasing complexity and interdependencies arising from the evolution of the financial system. This concern arises because recent changes in financial conditions may have generated new ways in which debt default can spill over into the banking system. Finally, we address some of the policy issues related to these concerns.

Concluding Comments

It is obvious that the Federal Reserve has legitimate reasons to be concerned about the stability of the financial system and, consequently, about the level of GDP. One solution is to continue in direct proportion to nominal GDP. Although debt increased sharply during World War II, it has continued to rise. We also consider the possibility of an increase in debt in the future. If there is a consensus about the increasing private debt ratio, it is one that we should remain privy to the potential risks that attend more« The Federal Reserve certainly has the ability to provide massive liquidity to our financial system in a time of extraordinary distress, we can all agree that an ounce of prevention would be worth a pound of cure.

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Debt and Income

Debt cannot rise without limit in relation to the income needed to cover payments of interest and principal. For this reason, debt is commonly measured in relation to nominal GDP. Although the Federal Reserve certainly has the ability to provide massive liquidity to our financial system in a time of extraordinary distress, we can all agree that an ounce of prevention would be worth a pound of cure.

The recent surge in debt has raised some concerns among economists, particularly with its implications for the vulnerability of the financial system and the economy. A viable market-oriented financial system depends on a heavy preponderance of prudent decisions of private parties over imprudent decisions. Despite recent efforts to quantify financial risk and to establish precise rules for managing it, prudent management of financial risk remains a matter of judgment. Moreover, recent financial innovations and regulatory changes have altered the financial landscape and may be especially difficult to assess in terms of the implications of accelerated debt growth.

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For example, since the beginning of the current business expansion in 1982, more corporate bonds have been down-graded than upgraded. In addition, there has been an upward trend in delinquency rates on consumer and mortgage debt. This is understandable, as economic expansions and suggests additional exposure of households to the risk of default. A chief concern is that continued in-creases in the debt ratio ultimately increase the chances that debt service will become unsustainable in the aggregate. A fundamental risk in debt accumu-lation is that borrowers may overestimate the growth potential for aggregate income. It is feared that they may strive to take advantage of the potential for sustained periods of general economic stagnation. Moreover, we have seen financial strains in several sectors of the economy—agricul-ture, energy, foreign transactions, and real estate—in which many bor-rowers were too optimistic about the growth potential of these sectors, if not that of the economy.

In addition, some analysts argue that the upward trend in private debt partly reflects a number of institutional changes that have increased the risk-taking than borrowers would have accepted in the past. It is feared that these may be actuarially fair in the aggregate).

Debt and Stability of the Financial System Some economists have argued that the potential for increased economic stress may be linked to larger swings in the business cycle.2 This view is based on an understanding ofUP. The competitive pressures on banks. Over-

curred in 1837, 1857, 1873, 1884, 1897, 1907, and 1933. A catalyst in the process of sys-te
crime that the failure of one bank can lead to the failure of others. The moral hazard problem is inex-

leleven instances of bankruptcy. The FDIC has also found that large institutions have sometimes rational for the insured to become less concerned about risk. This is known as the moral hazard problem. When the costs of deposit insurance are low and the benefits of risky behavior are high, a moral hazard is created.5 If the deposit insurance is too high, then the moral hazard is exacerbated.

Incentive Problems The increasing use of open-market in-

10. In recent congressional testimony, Federal Reserve Chairman Paul A. Volcker stressed the need for further exploration of the difficult and complex issues raised by rapid debt growth. See

4. For a more complete discussion of this issue see James Thompson, “Equity, Efficiency, and Deposit Guarantees; A Re-Examination of the Evidence,” Federal Reserve Bank of Cleveland, July 15, 1985.

5. It is interesting to note that FDIC premiums are not necessarily underestimated, since historically only insured banks have been subject to the premiums (they have been actuarially fair in the aggregate). However, FDIC insurance pricing does create a moral hazard because individual premiums are not risk-related.


8. See Friedman, op. cit.
For example, since the beginning of the current business expansion in 1982, more corporate bonds have been downgraded than upgraded, a trend that has continued through 1984. In addition, there has been an upward trend in delinquency rates on consumer and mortgage debt. This is usually due to an economic expansion, and suggests additional exposure of households to the risk of default.

A chief concern is that continued increases in the debt ratio ultimately increase the chances that debt service will become unsustainable in the aggregate. A fundamental risk in debt accumulation is that borrowers might allow debt service to overtake the potential for sustained periods of general economic stagnation. Moreover, we have seen financial strains in several sectors of the economy—agriculture, energy, foreign transactions, and real estate—in which new borrowers were too optimistic about the growth potential of these sectors, if not that of the overall economy.

In addition, some analysts argue that the upward trend in private debt partly reflects a number of institutional changes that reduce the inherent risk-taking than borrowers would have accepted in the past. It is feared that these changes may allow borrowers to take on risks of the potential for insolvency that are not consistent with the well-being of the economy.

Debt and Stability of the Financial System

Some economists have argued that the potential for increased default risk, and the debt structure to risk may lead to large swings in the business cycle. This view is based on the notion that increased default risk than borrowers would have accepted in the past. It is feared that these changes may allow borrowers to take on risks of the potential for insolvency that are not consistent with the well-being of the economy.

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ECONOMIC COMMENTARY

Debt Growth and the Financial System
by John B. Carlson

Federal Reserve Bank of Cleveland October 15, 1986

Debt cannot rise without limit in relation to the income needed to cover payments of interest and principal. For this reason, debt cannot be measured in relation to nominal GDP. There is, however, no particular basis in standard economic theory for arguing that the nation’s welfare is best served by any particular value of this ratio, nor is the recent increase in this ratio alarming in itself. Yet the vulnerability of debt to income between 1961 and 1982 seems, in retrospect, to reflect largely a coincidence of diminishing federal needs in the face of increasing private needs.

The federal government, while running budget deficits, was nevertheless borrowing a declining share of national income. Private borrowing, on the other hand, trended upward relative to national income over most of the period. Only after 1982, when federal borrowing needs sharply diminished, did total domestic nonfinancial debt (DNFD) rise sharply above the 1982 level.

Many factors can account for the increasing private demands for debt after World War II. Two groups of factors explain part of the pattern of household debt. One of these factors is demography, especially an acceleration in household formation; the other is the proliferation of bank credit cards, which are convenient for the increasing use of their transactions. Neither of these factors suggests cause for alarm. Deductibility of mortgage and consumer debt interest payments for tax purposes also helps explain the increasing attractiveness of household debt in the postwar period. Developments in corporate finance that increased access to credit markets by previously excluded businesses formed another. These factors, taken by themselves, suggest a rational basis for the increasing private debt ratio. However, some market observers do not find it comforting that there are many reasonable explanations for the substantial increase in household debt.

John Carlson is an economist at the Federal Reserve Bank of Cleveland. The author would like to thank Mark Steuerwald, E.J. Stein, and Walter Todd for their helpful comments.

1. Although these factors account for the underlying trends in debt growth, there remains something of a puzzle as to why recent acceleration in debt has been so strong.
3. Some economists would argue that the likelihood of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is nil, provided the central bank supplies sufficient reserves to offset the impact of such financial collapse is.