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Debt is capitalism's dirty little secret

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By Ben Funnell
Published: June 30 2009 19:14 | Last updated: June 30 2009 19:14

Just why is there so much debt in the Anglo-Saxon world? Bankers and regulators know well that it is in nobody's long-term interests to have allowed borrowing to escalate to a position where the US now owes far more, as a multiple of the economy, than at the start of the Great Depression.

The answer is capitalism's dirty little secret: excessive lending was the only way to maintain the living standards of the vast bulk of the population at a time when wealth was being concentrated in the hands of an elite.

The amount by which the elite has benefited is startling, and illustrates the problem with lightly regulated free markets: the rich get much richer while the rest do not get richer at all. According to Société Générale economists, the inflation-adjusted income of the highest-paid fifth of US earners has risen by 60 per cent since 1970, while it has fallen by more than 10 per cent for the rest. As was recently pointed out in the New York Review of Books, the Walton family, of Wal-Mart fame, is wealthier than the bottom third of the US population put together – about 100m people. These are staggering statistics, confirmed by measures such as the US and UK's ever-rising Gini coefficients, which estimate income disparity. Another way of putting this is that the share of profits in gross domestic product is at a 100-year high, or was until very recently.

Put simply, the benefits of economic growth have gone into the pockets of plutocrats rather than the bulk of the population. So why has there been no revolution? Because there was a solution: debt. If you couldn't earn it, you could borrow it. Cheap financing was made widely available. Financial innovations such as the asset-backed securities market aided this process, as did government-sponsored agencies such as Fannie Mae and Freddie Mac. Regulators welcomed it all while perhaps taking insufficient account of the moral hazard problem it posed: that ever-increasing leverage meant the authorities had to keep interest rates low, otherwise the debt burden would cripple consumption. This prompted more leverage, which exacerbated the problem.

A walk in any low-income area in the UK confirms this. There are BMWs in the driveways, satellite dishes on the roofs and furniture delivery vans on the streets. In both Britain and America the jobless were encouraged to buy their own homes. No one begrudges anyone else the right to own a home or buy luxury goods. The problem is that the luxuries need to be paid for out of earnings and the houses out of equity topped up with an affordable amount of debt.

The question is whether the debt load – total US credit market debt outstanding was $53,000bn (€38,000bn, £32,000bn) at the end of March, or 3.7 times GDP – is at all sustainable and, if not, how it can be lowered without sinking the economy. Those pushing extra debt in an effort to boost the economy via increased consumption point to the scale of assets backing the debt. The **net worth** of US households, including their houses and after counting debt, was $50,000bn in March, according to the Fed. Not a bad tally for 306m people: $165,000 each. However, the cost of servicing this debt as a proportion of income, even with record low rates, is at a 30-year high, above 15 per cent, as incomes have stagnated and the total level of debt has risen.

The debt burden has to come down, which means more saving and lower economic growth for many years to come. Along the way **inflation** is likely to return, probably sooner and more violently than most expect, which will prompt investors to demand a higher return and make it even harder for governments to tackle the debt. At best the debt will fall slowly over many cycles and simply trim otherwise resilient growth. At worst it could cause growth to lurch upwards before tumbling again, with all the attendant uncertainty that entails. At this point, no one can know which is more likely. I incline to the more benign view because of the size of household assets but, if the dollar's reserve currency status should come under serious attack, rates would have to rise to defend it and that could itself cause a consumption crisis.

What can be done? First, although it is not ideal, we should not be too hasty about abandoning the capitalist model. It is less bad than any other system yet invented. But we should redouble our efforts to increase productivity through innovation and creating new markets; simply squeezing lower-income workers is a bad option, which helped get us into this mess in the first place. This requires investment in education and research. Second, we have to learn to live within our means. This means spending less than we earn, perhaps doing without the BMWs, flat-screen television sets and leather sofas. Third, we should be careful in distributing the higher tax burden that we will inevitably have to bear over the coming decade. Very high marginal tax rates did not work in the 1970s and will not work now. That said, income disparity at current levels is a political time-bomb that needs to be dealt with. Finally, we should all come to terms with the fact that these are structural issues needing structural solutions; they need to be enforced over a longer time period than any one government's term. So we need a new political consensus, one aimed at reducing overall debt levels while reducing inequality by encouraging education, entrepreneurship and investment in innovation.

The writer is an asset manager at GLG Partners

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