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Learning to Live With Debt

By FLOYD NORRIS

Debt can kill. But you can't live without it.

Seldom have those twin realities been as stark as they are now. It was excessive debt brought on by too-easy credit that brought down the American economy and allowed some European countries to borrow money they will never be able to pay back. It is fear of debt that threatens to keep the United States from doing much to prevent a double dip [recession](#).

A considerable part of the current economic strain stems from the fact that the credit overhang continues to haunt borrowers around the world. The lenders may have been bailed out, but the borrowers were not — or at least not enough to return them to health. Millions of Americans remain underwater on mortgage loans. Countries that lack printing presses for their own currency find themselves unable to borrow from private lenders.

In the long run, inflation may be a significant part of the solution, enabling borrowers to pay back dollars and euros that are worth a lot less than the ones they borrowed. The soaring price of gold, now around \$1,650 an ounce, makes sense only if you assume something like that is going to happen.

But for now, such inflation is not on the horizon. To get by, the sad reality is that those who can raise capital may need to do so for the benefit of others. Germany has grudgingly moved toward that with

the latest bailout of Greece, but the United States — which now pays 2.4 percent to borrow money for 10 years, more than a percentage point less than it paid six months ago — seemingly has no desire to try to save its own economy, let alone anyone else's.

The effort to slash spending with the possibility of a new recession looming may be foolish. [Larry Summers, the economist and former Treasury secretary, pointed out in The Financial Times](#) this week that tax receipts over the next decade would be about \$1 trillion lower — and debt that much larger — if economic growth were shaved by half a percentage point a year. That is about the same amount that the bill passed this week claims it will save.

It appears that not much of that saving will be in the next couple of years, although the further cuts promised late this year could change that.

What is needed now is both a willingness to spend to offset the impact of the last debt debacle and a determined effort to ensure it does not happen again. But those efforts are stalling. Banks are lobbying with some success in both the United States and Europe to delay and weaken capital requirements.

And the American government shows no interest in doing anything about the incentives in current law that favor borrowing over equity. If you buy a house with the largest mortgage possible, you will pay lower taxes than if you borrowed less. Companies pay interest on loans out of pretax income, so the more they owe, the less they pay in taxes. But dividends are paid out of after-tax money.

“The U.S. tax system encourages household leverage and bank leverage, even though both are potentially destabilizing,” is the way Narayana Kocherlakota, the president of the Federal Reserve Bank of Minneapolis, [put it in a recent speech](#). He offered a rather modest suggestion: lower the proportion of interest payments that are deductible.

There are, of course, claims that both tax policies produce greater good for the society, by encouraging homeownership and corporate investment. He suggested “replacing the mortgage interest deduction with a tax credit that offsets part of a buyer's down payment toward a home purchase. Such a tax credit

would encourage homeownership without simultaneously providing more incentives for households to accumulate more debt.” And lower corporate income tax rates, he said, could offset reductions in the deductibility of interest “without simultaneously providing incentives for corporations to acquire leverage.”

The fact that those suggestions have virtually no political support reflects one of the great political and economic challenges of this era: Governments now feel a need to encourage economic growth, but don't want to spend money. Encouraging leverage seems like a good idea.

But it does have major risks. “A financial system with dangerously low capital levels — hence prone to major collapses — creates a nontransparent contingent liability for the **federal budget** in the United States,” said Simon Johnson, an M.I.T. economist and former chief economist of the International Monetary Fund, in Congressional testimony last week. “This can only lead to further instability, deep recessions, and damage to our fiscal balance sheet, in a version of what the Bank of England refers to as a ‘doom loop.’ ”

In plain English, he means Uncle Sam will get stuck with the debt when banks blow up. The fact that happened in the recent cycle is a major cause of the rising debt that seems so alarming to those who demand immediate cuts in spending totally unrelated to the financial crisis.

To hear banks tell it, every extra dollar of capital that they are forced to hold is one dollar less they can lend, and one dollar less of economic growth that the world desperately needs.

Economically, that may not make much sense. Anat Admati, a Stanford economist, argues that capital rules may force banks to change the mix of financing, but not the level. They can, she argues, simply issue more equity and have the same amount of money available to lend. And, she suggests, they will be a lot safer.

Such a strategy would reverse decades of growing leverage on bank balance sheets, and it could mean lower returns on equity, which is often the measure banks use in setting **executive compensation**. It

would make bank failures much less likely, but “too big to fail” institutions may see little need for it.

Bank capital rules historically were a cause of the problem at least as much as they were an effort to deal with it. It is not only the level of required capital that matters, but the way it is computed. The rules allow banks to measure “risk-adjusted assets,” so they have to hold little or no capital against low risk assets. That may make sense in theory, but in practice it was possible for banks to game the system by loading up on assets that were measured as very low risk even if they were not.

That was one reason so many banks thousands of miles away from the United States owned large amounts of securities backed by American subprime mortgages. The rating agencies said they were AAA, so profits could be earned at no cost to capital. Whoops.

Similarly, the old rules said that banks could lend to their own governments with zero risk. In Europe, that was extended to include all governments in the [European Union](#). Now there is much hand-wringing over the fact that banks have huge exposures to Greece and other peripheral euro zone countries, and must raise large amounts of new capital.

You might think new rules would do something about that. But bank regulations are set by governments, and governments want to be able to borrow as cheaply as possible. On July 20, the [European Commission proposed new rules for bank capital](#). Those rules specified that loans to member states should be treated as having zero risk, so long as the country was borrowing in its local currency.

That was one day before a European summit ended in an agreement that will cause banks to take substantial losses on euro-denominated loans to Greece.

In Europe they want to pretend that some risky assets are really perfectly safe. In the United States, fear that this country could somehow be a new Greece was whipped up to justify inaction in the face of evidence that the economy could be in danger of sliding into a new recession. Stock markets sold off around the world over the last two weeks, with Thursday the worst day yet.

Charting a course that ameliorates the problems left by the last leverage fiasco while minimizing the chances for a new one was never going to be easy. So far, neither Europe nor the United States is doing a very good job.



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