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EIR Economics

America in the 1990s: a decade of debt

by John Hoefle

There is nothing wrong with a society incurring debt, if that debt is used to increase the productive power of that society. In a properly run economy, spending money today to build the technology and infrastructure to increase the productive power of the workforce of tomorrow, is not only acceptable, but necessary. The costs of such projects are often great, but the payoff in future years is even greater. The drive to put a man on the Moon, for example, returned $14 in benefits for every $1 we spent, because of the scientific and technological breakthroughs it generated.

However, when debt is incurred to pay off other debts, or to cover shortfalls in income, the result is far different. Such debt does nothing to increase the productive power of society, but instead increases the overhead claims against the productive sector. When a national economy engages in this type of entropic process, the ultimate result, if policies are not changed, is bankruptcy.

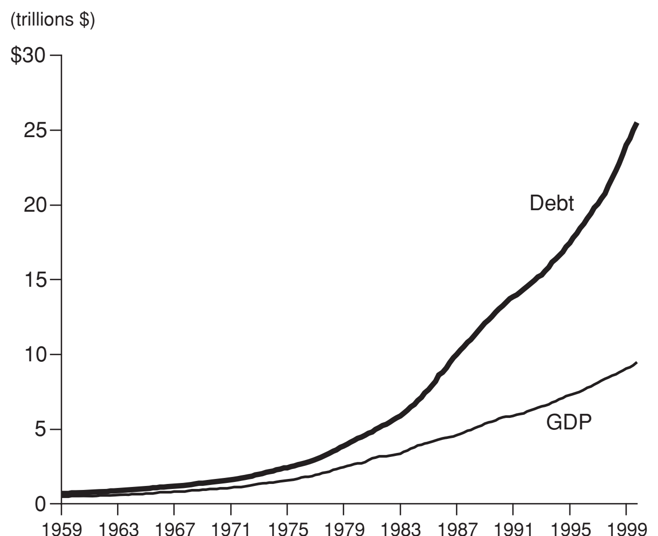
Most of the debt incurred in the U.S. economy over the last three decades has been of the latter character, with the predictable result.

Debt doubles

The level of debt outstanding in the United States nearly doubled during the 1990s, topping $25 trillion as of Sept. 30, 1999, the latest figure available. By comparison, the debt stood at $1.5 trillion at the end of the 1960s, $4.3 trillion at the end of the 1970s, and $12.8 trillion at the end of the 1980s.

The debt is growing much faster than the nation's Gross Domestic Product, indicating the entropic nature of the economy (**Figure 1**). During the 1990s, the debt in the U.S. economy, as measured by the Federal Reserve's Flow of Funds, grew by $12.2 trillion, or 95%. During that same period, U.S. GDP rose by $3.9 trillion, or 69%.

FIGURE 1
Growth of credit market debt outpaces U.S. Gross Domestic Product, 1959-99
(trillions $)



Source: U.S. Federal Reserve.

During the 1990s, the U.S. economy went $3.26 deeper in debt for every $1 of increase in GDP, compared to $2.92 in the 1980s and $1.68 in the 1970s (**Figure 2**).

When one considers that the productive sector of the economy accounts for about one-third of GDP, while overhead sectors account for two-thirds, the picture is actually much worse than the Fed's figures indicate.

Not surprisingly, the sector of the economy going the most deeply into debt during the decade was the financial sector, with a 206% increase, compared to a 61% increase in Federal government debt, a 76% increase in what the Fed

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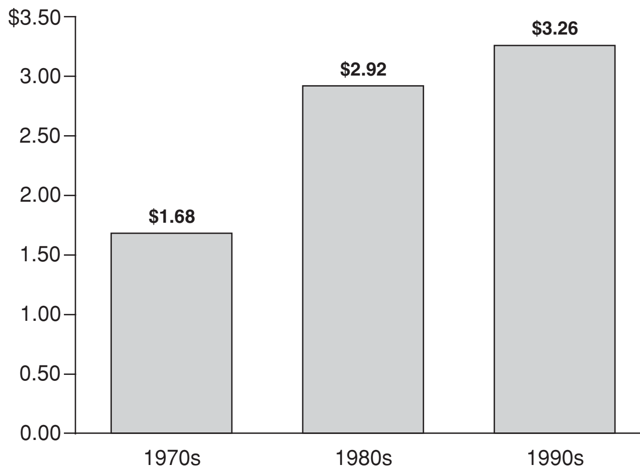
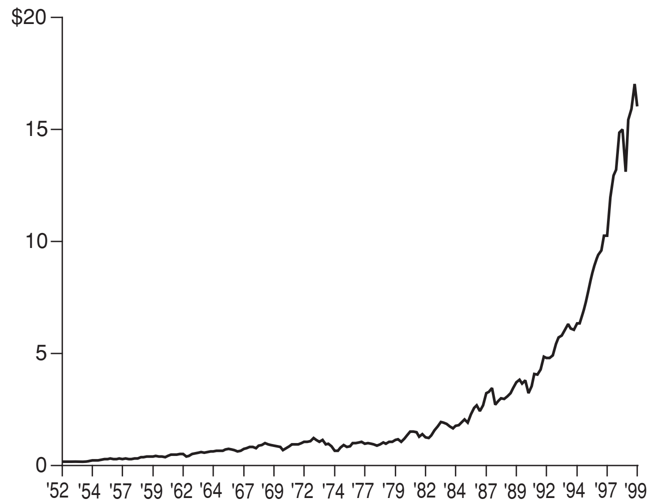
FIGURE 2
Rise in debt for each $1 growth in GDP



Sources: U.S. Federal Reserve, *EIR*.

FIGURE 3
Growth in corporate equities, 1952-99
(trillions $)



Source: U.S. Federal Reserve.

terms non-farm corporate debt, a 31% increase in the debt of state and local governments, and a 26% increase in the debt of farm businesses.

Within the financial sector, the largest increase was the 661% rise in debt owed by issuers of asset-backed securities. Asset-backed securities (ABS) are a form of derivatives, in which securities are issued against the income stream generated from underlying assets. The debt owed by real estate investment trusts (a form of real estate mutual fund) rose 502%, and the debt of government-sponsored enterprises (GSEs) rose 297%.

Overall, the financial sector had assets of $19.1 trillion as of Sept. 30, 1999, of which $4.5 trillion was held by commercial banks, $2.2 trillion were in Federally related mortgage pools, $1.9 trillion were held by life insurance companies, $1.4 trillion by ABS issuers, and $1.3 trillion by GSEs. Savings and loan institutions accounted for $1.0 trillion in assets.

Of perhaps more immediate interest to many of our readers, are the $1.1 trillion in mutual funds and the $1.0 trillion in money market mutual funds; and the $1.0 trillion in private pension funds and $733 billion in state and local government retirement funds.

By comparison, what the Fed terms the domestic nonfederal nonfinancial sector had assets of just $3.0 trillion, of which $2.0 trillion were held by the household sector (and against which the household sector owed $6.3 trillion in debt), and $248 billion were held by the nonfinancial corporate business sector.

If one compares the $19.1 trillion in financial sector assets with the $7.3 trillion in financial sector debt, it might seem that the debt burden is under control. That misperception disappears rather quickly, once one considers the nature of the assets in question, which are largely fictitious paper titles whose claimed value is wildly inflated by the largest financial bubble in history. As we saw with the collapse of the real estate bubble in the United States in the late 1980s, these "assets" can evaporate faster than an ice cube on the sidewalk on a hot summer day. With nearly four-fifths of all U.S. assets held by the financial sector, the day of reckoning will be quite brutal.

Off-balance-sheet money

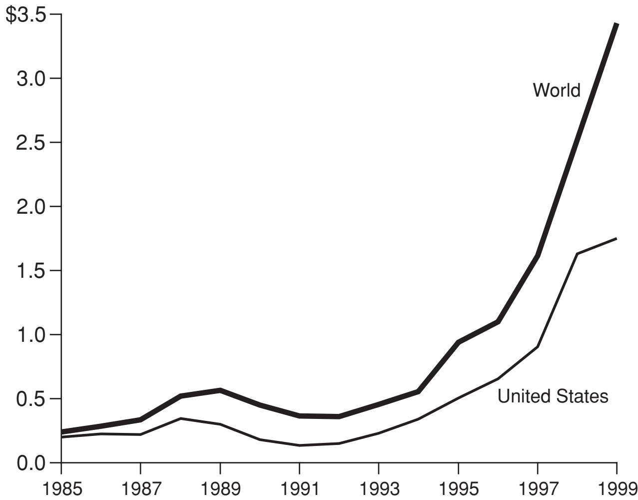
Coincident with the rapid rise of the bubble, has been the rise in the value of the market value of corporations, as measured by the aggregate value of shares issued. As of Sept. 30, the value of this corporate equity was $16 trillion, a rise of $12.2 trillion during the decade, and more than four times the $3.8 trillion at the end of the 1980s (**Figure 3**).

Federal Reserve Board Chairman Alan Greenspan and other foolish people have referred to the rapid rise in the market value of stocks and other financial instruments as "wealth creation," the basis of their claims about the "fundamental strength" of the U.S. economy. But, at bottom, it is just a mountain of unpayable IOUs.

Still, as long as the markets perceive that these gambling markers have value, they can be traded as if they were actual money.

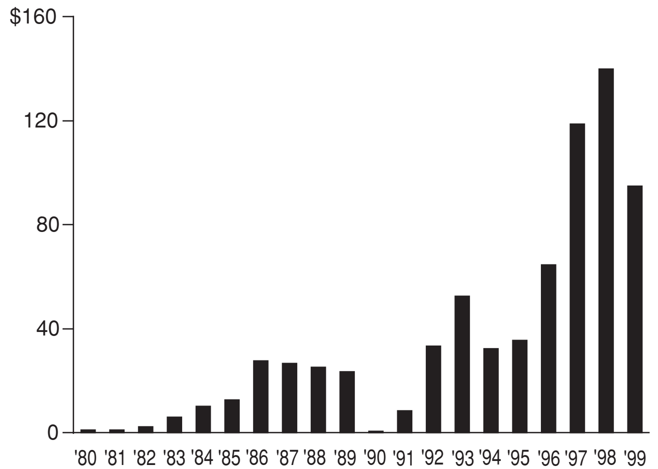
This is nowhere more true than in the mergers and acquisitions market, where stock has become the currency of the day, a sort of off-balance-sheet money. During the heyday of the 1980s, the weapon of choice in the M&A market was the leveraged buyout, in which takeover bandits such as Kohlberg

FIGURE 4
Growth in mergers and acquisitions
(trillions $)



Source: Thomson Financial Securities Data.

FIGURE 5
Increase in junk bonds issued, 1980-99
(billions $)



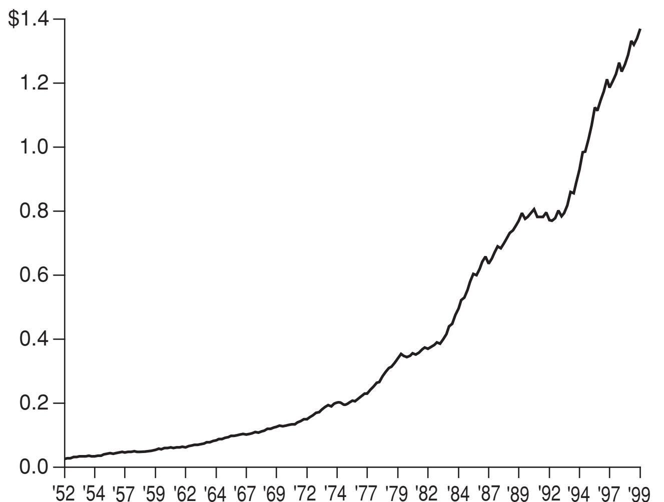
Source: Thomson Financial Securities Data.

Kravis Roberts (KKR) and the "Milken's monsters" of Drexel Burnham Lambert, would borrow huge amounts of money to take over corporations. The 1989 takeover of RJR Nabisco by KKR, for what was at the time a staggering $26 billion, capped a frenzied decade, and sucked so much capital out of the system that the M&A market went into a decline for several years.

However, the rapid growth in stock market valuations has opened the door to a vastly larger wave of takeovers, funded by stock swaps. In a stock swap, the acquiring company does not pay for its purchase with cash, but with stock, issuing its own shares to the shareholders of the target company. By using the wildly inflated value of their own shares as a form of money, companies are able to merge on a scale which makes the merger binge of the 1980s look like peanuts (**Figure 4**). The $180 billion takeover of Germany's Mannesmann by Britain's Vodafone is just the latest in a series of deals which would be impossible, were actual money required.

Even the junk bond market, which nearly died with the collapse of Drexel, has seen a remarkable resurgence (**Figure 5**). Some $95 billion of junk bonds were issued in 1999, down from $140 billion in 1998 and $119 billion in 1997, but well ahead of anything in the 1980s. In fact, more junk bonds were issued in 1998 alone, than in the entire decade of the 1980s.

FIGURE 6
Growth of consumer credit, 1952-99
(trillions $)



Source: U.S. Federal Reserve.

Households in debt

While some people are profiting mightily—if only in the short-term—from this IOU frenzy, the level of debt in U.S. households is growing rapidly. As of Sept. 30, as mentioned earlier, the household sector owed $6.3 trillion, an increase of 91% during the 1990s.

The Fed lumps households and non-profit organizations together in its Flow of Funds statistics. According to the Fed, this sector had financial assets of $31.9 trillion at the end of September—more than double the $14.2 trillion at the end of 1989—against liabilities of $6.6 trillion. Of those assets, $9.5

trillion were in pension fund reserves (much of which is invested in stocks), $6.6 trillion were in direct stock holdings, $4.2 trillion were in bank and money market deposits, and $2.7 trillion were in mutual fund shares.

Of the debt in the household sector, $4.4 trillion was in home mortgages, and $1.4 trillion was in consumer credit. The sharp rise in consumer credit in the 1990s, up $577 billion over the $793 billion at the end of the 1980s (**Figure 6**), reflects not only heavy borrowing against the fictitious capital flooding the markets, but also the shortfall in household income during the period. Millions of people are living off their credit cards, and when that runs out, they are forced into bankruptcy. Some 10.7 million bankruptcies were filed during the 1990s, more than twice the number filed in the 1980s. That figure includes more than 546,000 businesses and 7.6 million individuals.

But even that is only the beginning. Worldwide, there are some $300 trillion of financial claims outstanding, and not nearly enough productive economic activity to pay the bills. The gross world product, also known as world GDP, stands at some $41 trillion, and a large percentage of that figure represents overhead. That puts the ratio of financial claims to productive activity somewhere north of 10 to 1, and getting worse. The global financial system itself is bankrupt, and the United States, with its record debt and derivatives exposure, is sitting at ground zero of the coming explosion.

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The euro falls, and falls, and falls . . .

by William Engdahl

Just before the euro's official launch as a central bank unit of account on Jan. 3, 1999, many leading European politicians and bankers were boasting that the advantages of the new euro super-currency meant that it soon would challenge the role of the dollar as leading world reserve currency. European politicians, from French Finance Minister Dominique Strauss-Kahn to conservative French President Jacques Chirac, blew this trumpet in the months before January 1999. They were echoed by some of Europe's leading bankers, including Deutsche Bank's Norbert Walter.

But, as of the beginning of February 2000, the euro has fallen to its historic low, breaking the psychologically important parity to the U.S. dollar, and the mood is anything but euphoric. As of this writing, the euro is being traded for $0.97, a fall of 17% against the dollar. Yet, to date, there is no hint that Europe's political establishment is even considering abandoning the failed experiment.

This, then, leaves the euro in a dangerous "no man's land." Technically, it is too weak to attract the billions in foreign investment its framers had expected a year ago. Politically, it is too entrenched to be abandoned without risking a political and monetary collapse of the entire European Union (EU).

When the European Central Bank surprised observers and raised its central interest rate on Feb. 3, ECB President Wim Duisenberg cited "concern" about the low euro as the reason, adding to market jitters. This worsening crisis of confidence in the euro experiment now has the potential to interact with the global financial fragility, above all in the U.S. NASDAQ stock market bubble and in Japan's debt-bloated economy, to create systemic crises of unimagined dimension.

Frictions and fracture lines

As the euro declines, the prospect of splits among European Monetary Union (EMU) member-states is emerging, which adds to the growing political instability at a most dangerous time. The unprecedented clash between the other 14 EU member-states, which have threatened to blacklist Euroland member Austria, because they disapprove of the choice of Austrian voters in putting the party of right-wing populist Jörg Haider into government, is making potential foreign euro investors even more nervous.