Sense from Krugman on private debt

I was highly critical of Paul Krugman's recent academic paper on the financial crisis, because it argued, on neoclassical *a priori* grounds, that:

> *Ignoring the foreign component, or looking at the world as a whole, the overall level of debt makes no difference to aggregate net worth — one person's liability is another person's asset. (p. 3)*

Given that criticism, I feel obliged to point out that in his recent comment on Rick Perry's nomination for the Presidency, "The Texas Unmiracle", Krugman makes a very sensible observation about the importance of "the overall level of debt" that contradicts the assumption he made in that paper. Observing that Texas's allegedly better performance on employment growth is due mainly to "cheap labor", Krugman comments that:

> *at a national level lower wages would almost certainly lead to fewer jobs — because they would leave working Americans even less able to cope with the overhang of debt left behind by the housing bubble, an* ***overhang that is at the heart of our economic problem****.*

Bravo! The aggregate level of private debt ***does*** matter, and simplistic attempts to make businesses feel better by lowering their wage costs may actually reduce their revenue even more as already debt-depressed households see their disposable income above debt servicing and repayments shrink dramatically.

Here Krugman repeats the wisdom of Keynes on the same point during the Great Depression. Generally I regard Irving Fisher as superior to Keynes on the causes of the Great Depression, because he focused on the role of debt and deleveraging whereas Keynes, by and large, ignored it. However on one occasion—when considering the argument that neoclassical economists were making that the Depression could be ended by a cut in wages, Keynes made the following comment:

> *"Since a special reduction of money-wages is always advantageous to an individual entrepreneur ... a general reduction ... may break through a vicious circle of unduly pessimistic estimates of the marginal efficiency of capital...*
>
> *On the other hand, the depressing influence on entrepreneurs of their greater burden of debt may partially offset any cheerful reactions from the reductions of wages. Indeed if the fall of wages and prices goes far, the embarrassment of those entrepreneurs who are heavily indebted may soon reach the point of insolvency--with severe adverse effects on investment." (Keynes 1936, p. 264)*

This points out the fallacy in neoclassical thinking that blames unemployment on wages being too high: since neoclassical theory ignores the role of debt, it imagines that dropping the price of labor will increase demand for it, by improving the profitability of firms. However as both Keynes and Krugman note, since private debt both exists and matters, cutting wages while leaving the level of debt unaltered can actually end up reducing demand by more than the fall in wages—leaving employer worse off than before.

Keynes also argued that a cut in money wages would also cause a fall in the price level, which would also increase the debt burden—though his statement of this was very convoluted, as was often the case when what he wrote challenged conventional theory:

> *"The method of increasing the quantity of money in terms of wage-units by decreasing the wage-unit increases proportionately the burden of debt; whereas the method of producing the same result by increasing the quantity of money whilst leaving the wage-unit unchanged has the opposite effect. Having regard to the excessive burden of many types of debt, it can only be an inexperienced person who would prefer the former." (1936: pp. 268-69)*

("An inexperienced person" was Keynes's satirical code for "a neoclassical economist")

In English, Keynes is saying that cutting money wages will reduce the price level, which will increase the real debt burden. This is precisely what happened during the early years of the Great Depression. Here Fisher is the one to read rather than Keynes: his 9-step process of debt deflation began with:

> (1*) Debt liquidation leads to distress selling… (Fisher 1933, p. 342)*

Which caused:

> *(3) A fall in the level of prices*

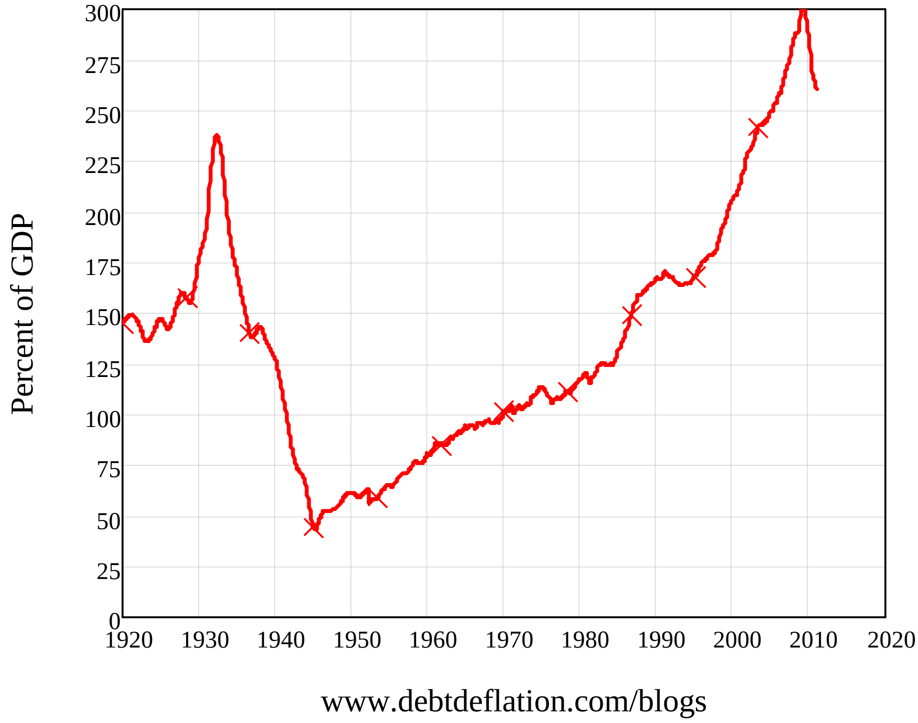
Leading to the paradox that:

> *"the more debtors pay, the more they owe. (Fisher 1933, p. 344)*

This is precisely what happened in the early, seriously deflationary stage of the Great Depression: businesses cut prices in an attempt to stimulate demand for their products, and paid their debt down with the proceeds, only to find that their real debt burden rose because the fall in revenue more than outweighed the reduction in debt.

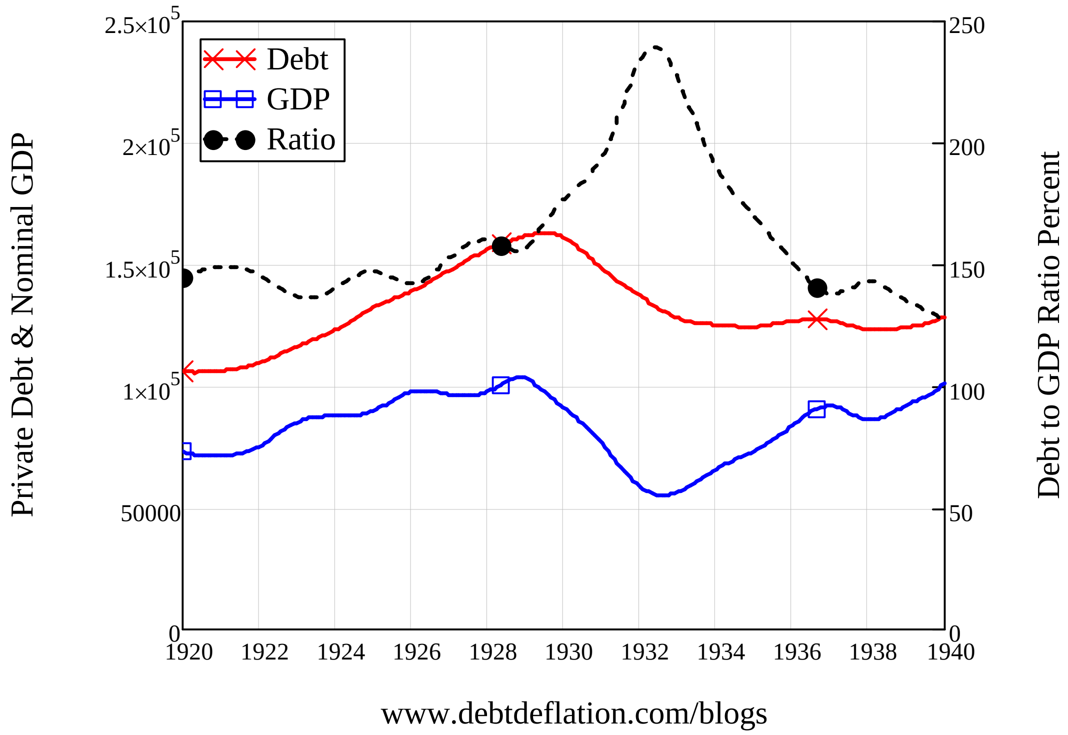
I normally present just the ratio of debt to GDP when talking about how excessive debt causes economic crises:

Figure 1: US Private Debt to GDP



But the really important story of the Great Depression is, as Fisher notes, is that the debt ratio rose *even though the absolute level of debt was falling*:

Figure 2: Rising Private Debt Ratio with Falling Debt



The same paradox applies when considering what might happen if wages are cut: by cutting wages *without reducing the level of nominal debt*, the debt burden will rise in real terms. It also leads to a paradoxical idea: the best way to reduce the debt burden might not be "printing money"—which Keynes in effect recommended in that second quote, and which Bernanke has in fact been trying—but *raising* money wages.

This wouldn't increase real wages—because employers would pass on the cost increase—but it would very directly cause inflation, and thus reduce the real burden of debt.

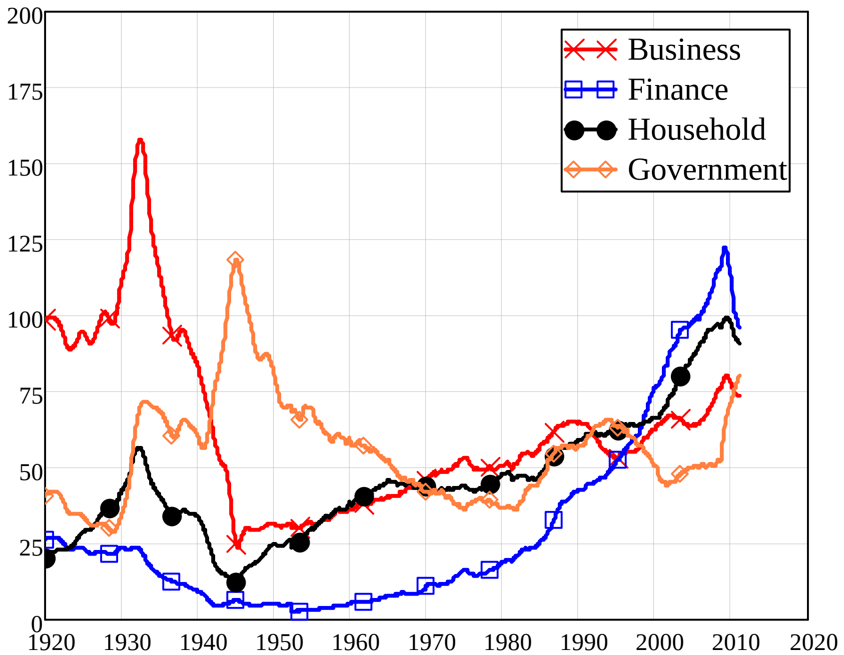
Of course, there's zero chance of that policy being tried, for at least two reasons. Decentralized wage setting means that there is no mechanism to do it in the first place, while both neoclassical economists and conventional pundits vehemently oppose wage rises anyway.

Here they're being a bit like amateur drivers who find themselves in a spin because they've driven too fast around a bend. Their response is to turn into the bend even more—which results in the car spinning even more out of control. Expert drivers (and I'm not one, I hasten to add!) know that in that circumstance they have to do the counter-intuitive thing of turning the wheel in the opposite direction.

The bend we're in is the process of debt-deleveraging, which as Richard Koo argues, turns conventional economic thinking on its head. But the way we're going, we'll behave like amateur drivers in a spin and make a bad situation worse by lowering wages during a debt-deflation.

Finally, one reason why deflation hasn't been as sharp this time as it was in the Great Depression—even though the private debt level is higher—is that non-financial businesses are actually in less debt now than they were then. Non-financial businesses entered the Great Depression with a debt to GDP ratio of 100 per cent—well above the 75 per cent level that applied at the start of our crisis. So they don't face the same direct pressure to service debts that led to the "distress selling" Fisher focused upon.

Figure 3: Debt to GDP by Sector



But households are in far worse shape now than in the 1930s, with a peak debt level that is two and a half times as high as it was in 1930. That's why the crisis now is manifesting itself in stagnant consumer demand. It doesn't involve the same plunge into deflation as the Great Depression, but it does imply a more drawn out deleveraging, because it's much harder for households to reduce debt than it is for businesses. Businesses can get out of debt by going bankrupt, sacking workers, and stopping investment. Households have to live with the shame of bankruptcy and the limitations it imposes on behaviour in future, they can't sack the kids, and it's impossible to stop consuming completely. So we may face a far more drawn out process of deleveraging than the Great Depression.

To return to Krugman's point, this is the last environment in which reducing wages makes any sense, however much appeal it might appear to have on a simplistic analysis.

Fisher, I. (1933). "The Debt-Deflation Theory of Great Depressions." Econometrica **1**(4): 337-357.
Keynes, J. M. (1936). The general theory of employment, interest and money. London, Macmillan.