INVESTING IN EDUCATION

BUILDING NEW BRIDGES

ESTABLISHING WORKER-TRAINING PROGRAMS

GOOD DEBT

HOW IT CAN HELP

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UPGRADING FACTORY EQUIPMENT

BREAKING GROUND ON NEW AIRPORTS

TAX DEDUCTIONS FOR SECOND HOMES

SUBPRIME AUTO LOANS

LOW-QUALITY MORTGAGES

BAD DEBT

HOW WE CAN FIX IT

HIGH-INTEREST CREDIT CARDS

WALL STREET–ENRICHING STOCK BUYBACKS

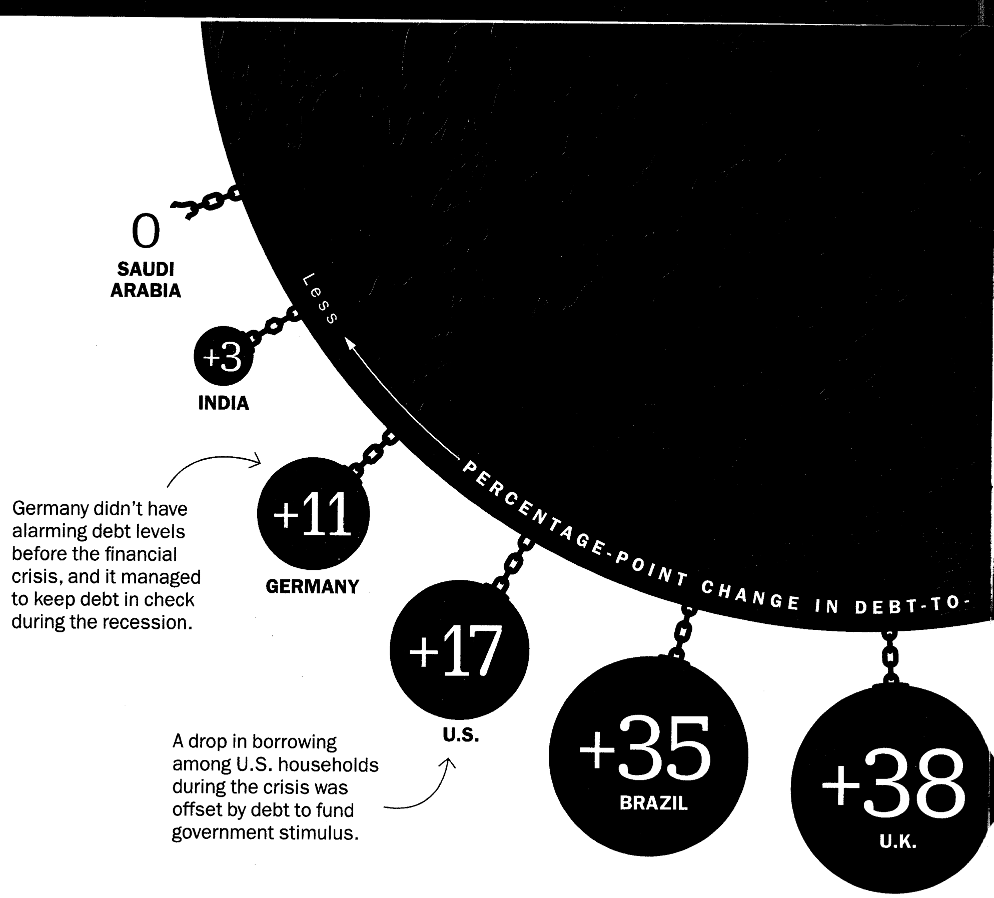
PRICEY VACATIONS

BY RANA FOROOHAR

A GLOBAL PROBLEM

Worldwide debt is nearly $200 trillion. Since 2007, few countries have reduced their debt-to-GDP ratios

REPORTING BY EMILY BARONE



Remember junk bonds?

We haven't heard much about this kind of risky corporate debt since they helped put the *go* in the go-go '80s and, eventually, tanked the stock market. So it may come as a surprise to learn that they're back—and unreformed. Junk bonds and a malodorous bouquet of similarly risky types of debt have proliferated in recent years. Lately some of them have been going bad, as investors have pulled a record amount of money out of the corporate-bond sector after defaults in areas like energy and manufacturing, which have been hit by the fall in oil prices.

Trouble is, this bond blowup isn't an isolated event. It comes amid larger market corrections in sovereign debt, commodities and major emerging markets like China, where government officials had to stop trading twice in January to stave off a stock-market collapse. At first glance, these events might appear to be disconnected. They aren't. All those markets has something in common, and it's the same thing that brought down the global economy in 2008: loads and loads of bad debt.

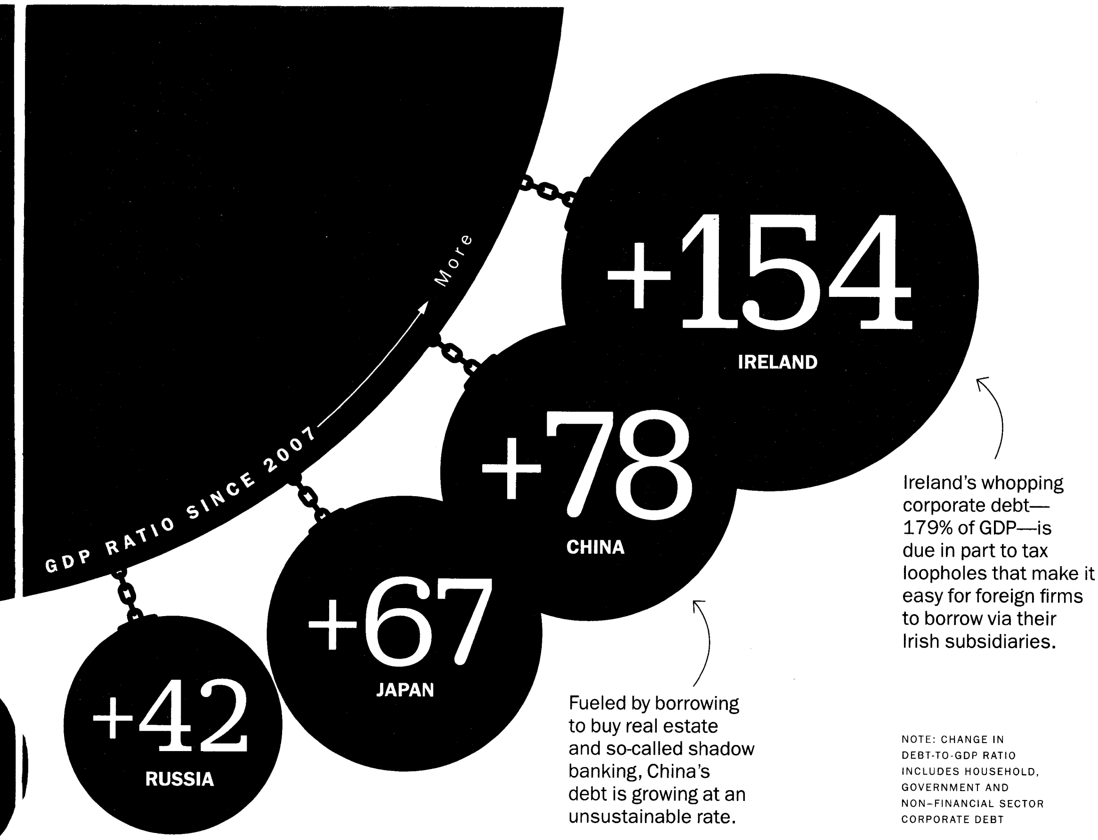
Eight years on from the debt-driven Great Recession and the financial crisis that followed, there's more, not less, red ink on the books than there was back then. In fact, there is an unprecedented amount of public, private and consumer debt in the world today—$57 trillion more than before the crisis. The total, according to calculations by the McKinsey Global Institute, now rings up to a staggering $199 trillion.

All of that red ink was fueled by the low interest rates of the past few years, which are themselves a central-bank reaction to the 2008 crisis. The idea was to keep money flowing throughout the global economy to encourage growth. But while the unconventional monetary policies led by the U.S. Federal Reserve and later copied by dozens of other central banks did indeed keep the economy afloat, they also encouraged an epic global credit boom.

If all this is starting to sound a little familiar, that's because almost nothing has changed in our economic landscape since the last crisis. We still have a global economy driven by debt rather than by productive investment. Academic research covering decades of data shows that debt is always at the root of financial crises. "A rapid increase in debt is the single biggest predictor not just of financial crises but of economic slowdowns, in countries both rich and poor," says Ruchir Sharma, head of emerging markets and global macro at Morgan Stanley Investment Management.

Quick debt run-ups are exactly what the U.S. experienced before the last crisis and what China and other emerging countries are going through now. In fact, says Sharma, since 1960 every country that has experienced a significant increase in private debt over a five-year period had a recession. This is just one reason that many economists now predict a global recession within the next couple of years.

Debt, in other words, caused the last crash, and it'll likely cause the next. To understand the volatility, uneasiness and outright fear in the global economy these days, you have to follow the debt.



The picture isn't entirely black (or red).

U.S. consumers are unlikely to be the source of the next meltdown. Consumer debt is generally the riskiest kind of debt for an economy. As academics Atif Mian and Amir Sufi pointed out in their influential 2014 book, *House of Debt,* that's because there's a strong connection between the level of household indebtedness and the magnitude of the decline in consumption during a recession. When people get too heavily in debt, they simply can't spend. That has a major effect on businesses in an economy that is 70% consumer spending like America's. Until households curb their borrowing, the economy can't grow robustly.

Americans cut their personal debt by 3.5% from 2007 to 2014. Not all of it has been intentional—housing foreclosures wiped a lot of consumer debt off the books, and debt is now rising once again in some areas, like subprime auto loans and student loans. But on the whole, U.S. consumers are less in the red than they were pre-2008. Household balance sheets are much stronger.

DEBT, IN OTHER WORDS, CAUSED THE LAST CRASH, AND IT'LL LIKELY CAUSE THE NEXT

Personal-savings rates have also remained higher than many economists would have predicted. That's very unusual: normally, as soon as the prices of assets like stocks and homes begin to rise, people feel more secure, reduce their savings and start spending again. But in the wake of the Great Recession, something changed. Since 2012, U.S. net wealth increased by $20 trillion, thanks to gains in both stock markets and housing, but the personal-savings rate still hovers around 5%. That's about double what it should be given such gains, according to research by JPMorgan.

The cause, say economists, could in part be America's aging population, since people spend less as they get older. But it is also true that most of that stock and housing wealth is accruing to a small subset of the population. (The richest 20% of the population owns roughly 80% of all stocks.) "The surge in household net worth during this most recent expansion has not been accompanied by equally impressive gains in income or income expectations," notes a December 2015 JPMorgan report on the topic. That disconnect between income and the "wealth effect," which in the past has driven spending, goes a long way toward explaining why American consumers are much less willing to go into debt than they used to be.

Already, this has been a drag on the U.S. recovery, and it may be a permanent one. History shows that when consumers go through a seismic economic event, it changes their behavior over the long term—think about Depression-era grandparents who learned in the 1930s to save their used tea bags. They never changed. Now it may be that the financial crisis of 2008 and the recovery that followed have bred a new type of American consumer, one simply less willing to consume.

The outlook isn't quite so rosy for U.S. companies.

American corporate debt as a share of GDP fell 2 percentage points from 2007 to 2014. But some of this is financial alchemy. Money and investment are moving abroad, while debt is increasing at home. About half of corporate America's cash trove is now held overseas so that firms don't have to pay the U.S.'s higher-than-average corporate tax rate. Instead they are increasingly stashing cash in Ireland, the Netherlands, Singapore and the Cayman Islands.

To be fair, there are some legitimate reasons for companies to keep more money overseas: one is that many emerging markets still represent strong long-term growth opportunities. As plenty of CEOs will tell you, even if the U.S. corporate tax rate goes down, there will still be high rates of growth in places like Indonesia, India or parts of Africa. Ultimately, companies want to invest where growth will be greatest, not just where tax rates are lowest.

The problem is that companies are still borrowing back at home. While total corporate debt fell, corporate-bond debt is approaching a record 30% of GDP. Companies have gone to public markets to raise money, taking advantage of those near zero borrowing costs. Increasingly, the entities holding that debt aren't Wall Street banks but the unregulated shadow-banking sector, including hedge funds, asset managers and money-market funds, which globally grew by $18 trillion since 2007, to $80 trillion in 2014. That debt hasn't gone away—it's just gotten harder to trace.

Most of that borrowed money has ended up in investors' pockets rather than in workers' salaries or such investments in the real economy as new factories and research and development. As University of Massachusetts professor William Lazonick has tabulated, from 2005 to 2014, S&P 500 firms spent $3.7 trillion on stock buybacks, representing 52.5% of net income, plus another 35.7% of net income on dividends. These companies held much of the remaining 11.8% of their profits abroad, sheltered from U.S. taxes.

The situation was even more stark last year. FactSet Research calculates that in the 12 months ending with September 2015, S&P 500 companies spent 64.6% of net income on buybacks, with 130 companies spending more than 100%—both record numbers since the 2008–09 financial crisis. These buybacks helped boost stock prices, but there's no evidence they've created many jobs.

This recipe is doubly problematic because it encourages the cycle of inequality. When the rich get richer, there are only so many more cars and pairs of jeans and houses they'll buy. But when wealth is more broadly shared, the economy grows more robustly. Laurence Fink, CEO of BlackRock, the world's largest asset manager, put it this way in an open letter to corporate America in 2014: "Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks." (On Feb. 2, Fink chided CEOs for focusing on quarterly targets instead of long-term investment.)

This trend of cash hoarding and debt-financed investor payouts doesn't just stymie growth; corporate debt can also create major risk in the markets. That's an alarm that some of the savviest investors, like Carl Icahn, have been sounding for some time now. "The average investor [has ended up in risky debt markets], and he doesn't know what he's buying because he's got a wealth-management guy telling him, Oh, here's a good deal," he says.

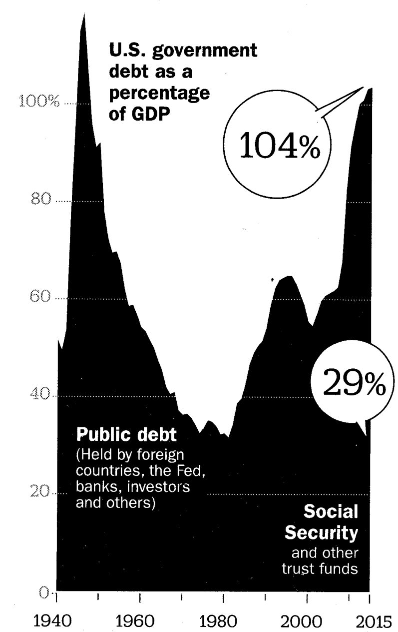
Usually, it's not so easy for lower-grade corporations to issue bonds and raise debt. But the Fed's monetary policies (which were themselves a reaction to an absence of more fiscal stimulus or other solutions from a gridlocked Congress) left investors looking for bigger payoffs, including junk bonds and other risky assets. Indeed, there's a good chance that your own retirement money could be in such risky securities, given that pension funds and many asset managers have piled into such investments en masse in recent years. A recent study by the American Federation of Teachers looked at 11 major pension funds with $638 billion in assets and found that about $43 billion of that money was in hedge funds and other sorts of funds that invest in riskier assets.

The nightmare scenario is that the

jitters in junk bonds spread to areas of the market that seem safe, as companies and investors holding bad debt are forced to sell off other parts of their portfolios to cover losses, triggering a downward market spiral like we saw in 2008. (There's little doubt that markets will be more volatile in 2016 than they were last year.) Investors and policymakers are also worried that the markets could seize up quickly if this happens. That's because investment banks, which have eschewed risky debt because of Dodd-Frank rules requiring them to hold higher-quality assets, are less likely to play the role of marketmakers of last resort these days. That means there is less liquidity in the markets in general, which makes the dominos likely to fall faster and harder when there is a disruptive event. The

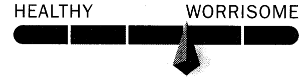
NATIONAL LIABILITIES

Federal, state and city governments

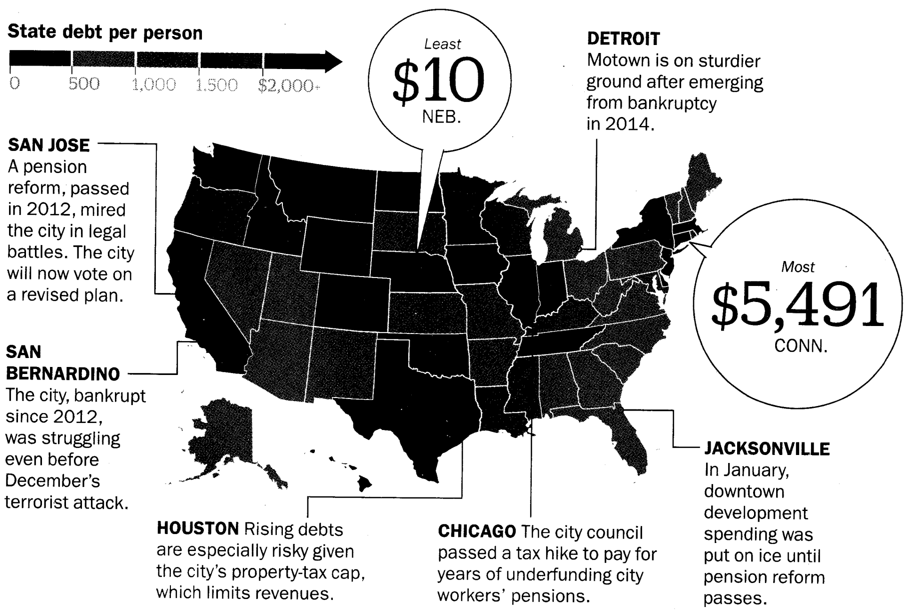


Government

U.S. debt swelled during the downturn, leaving the country more vulnerable to future crises. Separately, a growing stream of retirees are drawing from funds like Social Security, which totaled nearly 25% of federal spending last year.

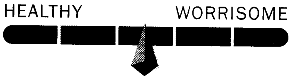


must pay down past debts while facing rising retirement costs



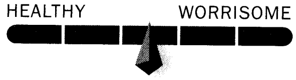
State

Thanks in part to growing tax revenues, many states are in better shape than they were a few years ago. But Illinois, Connecticut and Kentucky, among several others, are strained by debt and looming pension liabilities.



Municipal

Some strapped local governments that managed to escape the downturn without filing for bankruptcy may still face the music in coming years as expenses and pension costs continue to mount.



THIS RECIPE IS PROBLEMATIC BECAUSE IT ENCOURAGES THE CYCLE OF INEQUALITY

Treasury Department's Office of Financial Stability warned of the possibility of just such a liquidity crisis in its most recent market report.

Even a much-less-dramatic crash than the subprime crisis of 2008 would be complicated by the fact that public debt levels have grown so much that central banks wouldn't be able to pump cash into the system to fight another downdraft. In a global context, the U.S. public sector still looks pretty good on that score—it started with lower overall debt levels and has taken on much less since the crisis than countries ranging from Greece to Japan. State and city debt in particular is looking better than it did a few years back, when analysts like Meredith Whitney were predicting widespread municipal defaults. An increase in tax revenue combined with pension cuts in the wake of the crisis has put a number of regions in better shape. (Some areas are still in the red; *see graphic.*)

But federal debt is still rising. If you don't count entitlements like Social Security, it's now around 74% of GDP. But if current projections hold, it will reach over 100% of GDP by 2040, higher than at any point in U.S. history except the period during and after WW II. The reason? An aging population means higher health care and pension costs. (Including entitlements, U.S. debt is already at 104%.) Sooner or later, lawmakers will have to address the automatic spending that comes with the steady expansion of entitlements. "In many ways, the U.S. doesn't have a debt crisis—it has an entitlement crisis," says Susan Lund, research director for MGI.

Still, debt is debt, and levels like that will soon make it harder for the U.S. to pay the interest on its debt. That would in turn begin to undermine the standing of the U.S. in credit markets, which could, in a worst-case scenario, devalue the dollar and even wipe out wealth held in "safe" assets like Treasury bills. Such crushing debt burdens would also make it impossible for politicians to use tax and spending policies to respond to big challenges, like the 2008 financial crisis. It's already hard to imagine policymakers passing a fiscal stimulus in response to a new crisis like the last one.

And yet, even as it feels as if we've just emerged from the last recession, the next one may not be far away. We're heading into the seventh year of an expansion that started in 2009, and recessions happen every eight years on average. That's one reason that some observers, like Allianz's chief economic adviser, Mohamed

El-Erian, are predicting a 25% to 30% chance of return to recession in the U.S. by 2017. Others fear it is closer than that.

Addressing the debt issue—both the immediate problems

and the longer-term, systemic ones—is crucial to ensuring future growth. The next President needs to carve out a slow and steady path to federal-debt reduction, for example, since making big cuts all at once is a sure route to recession or even depression. Curbing the federal debt will require budgetary changes on both the spending and the borrowing sides. The conservative argument for tax cuts to bolster growth simply doesn't hold much water. Bill Clinton raised taxes in the 1990s and got great growth; George W. Bush cut them in 2001 and 2003 and got mediocre growth, and none of the Barack Obama tax cuts after the financial crisis did much to bolster it either. According to Pew Research, more than half of Americans actually think their taxes are fair.

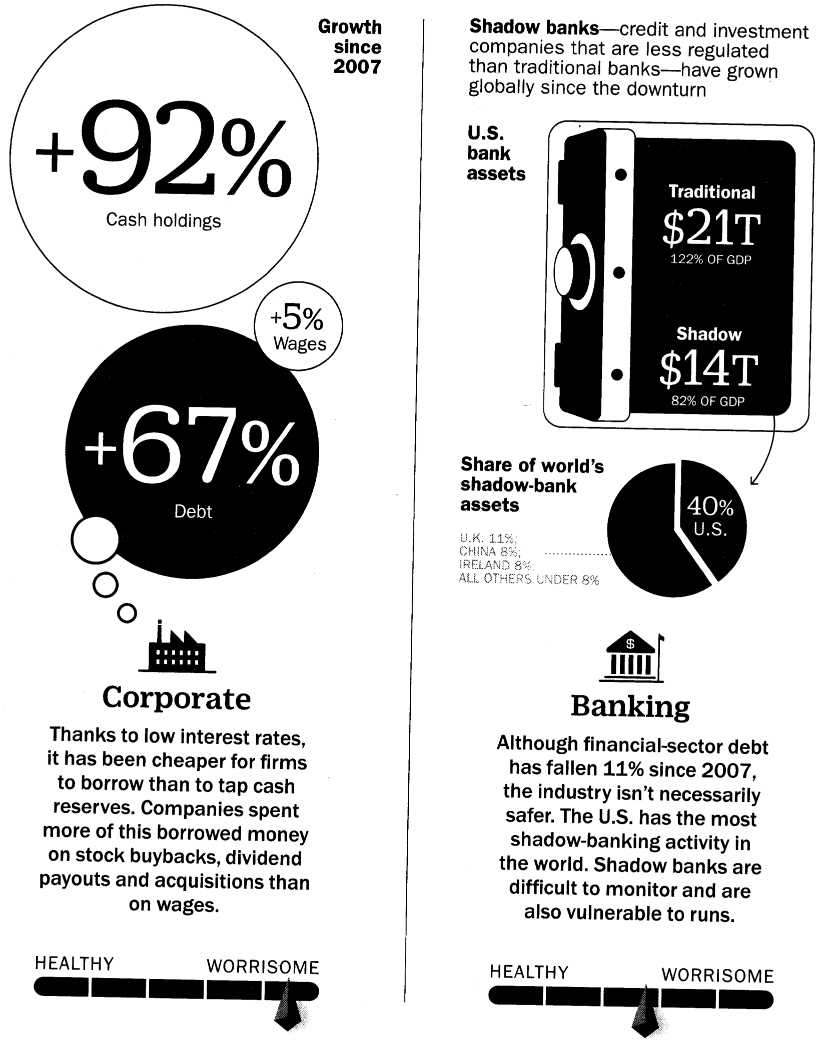
Curbing America's existing debt is only the start. Government needs to encourage stronger and more sustainable growth by changing the underlying market system that encourages all of us—companies, consumers and countries—to take on more debt. That should start with a soup-to-nuts rethinking of the tax code to make it favor savings rather than debt.

Why does our tax code reward borrowing so much? In large part because it's a way to mitigate the pain of larger structural changes in the economy. Stagnating wages can't fuel spending, so debt-fueled consumer finance becomes a saccharine substitute for the real thing, an addiction that just gets worse as it becomes less satisfying. India's central banker Raghuram Rajan, a former University of Chicago economist and one of the most prescient seers of the 2008 financial crisis, has argued that rising credit levels have become a palliative to address the deeper anxieties of downward mobility in the middle class. As Rajan puts it, "Let them eat credit" has become our collective answer to globalization and technology-driven job displacement.

Yet the U.S.'s existing tax code rewards exactly the kind of behavior the economy doesn't need. The rich can get second-mortgage tax credits on their yachts, for instance, provided they stay on them more than 14 days a year. (Congress tried and failed to close this loophole in 2014.) There are tax breaks for the use of personal-travel and corporate jets for "security reasons." Tax dollars help underwrite federal flood insurance in some of

WALL STREET TO MAIN STREET

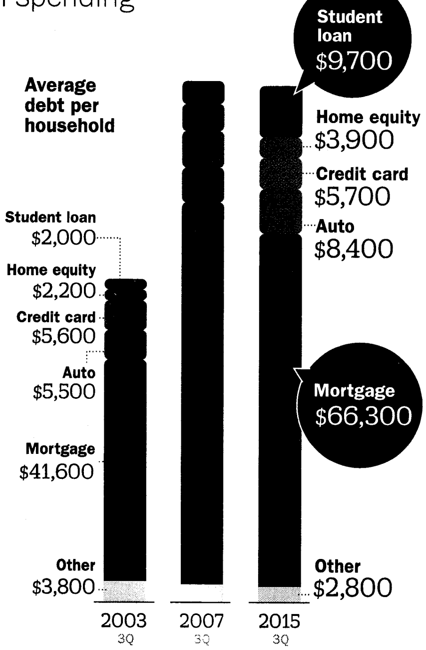
Large companies have accrued debt while consumers are still cooling off



SOURCES: MCKINSEY GLOBAL INSTITUTE; OFFICE OF MANAGEMENT AND BUDGET; CONGRESSIONAL BUDGET OFFICE; THE ROCKEFELLER INSTITUTE; MOODY'S; FACTSET; FEDERAL RESERVE; FINANCIAL STABILITY BOARD; EQUIFAX; CENSUS; NEWS REPORTS
NOTE: CORPORATE CASH AND DEBT FIGURES FROM S&P 500 COMPANIES; WAGE GROWTH BASED ON ALL NONGOVERNMENT FIRMS

THE U.S. TAX CODE REWARDS EXACTLY THE KIND OF BEHAVIOR THE ECONOMY DOESN'T NEED

ff :heir spending



Personal

Americans shed $1 trillion in mortgage debt after the financial crisis and tightened their belts in most respects. However, student loans are up 130% and have higher delinquency rates than any other type of personal debt.

the richest waterfront property areas in the country, a subsidy that mostly benefits wealthy landowners.

The most appalling fact: people who make money from making money are taxed at lower rates than those who work for it. Income from labor is taxed at a much higher rate than investment income. Warren Buffett famously took on this issue in 2011, noting that he paid a smaller share in taxes than his secretary, since he made money from things like carried interest on investments, capital gains from selling stocks and so on. The next President needs to work with Congress to fix these pieces of the tax code.

He or she should also look closely at reducing corporate tax subsidies for debt and closing loopholes that allow corporations to write off compensation awarded in stock options, which has fueled the corporate borrowing boom and encouraged much of the destructive, short-term boardroom behavior.

But housing is where the real debt—and the potential solutions for it—lie. Consider the mortgage-interest deduction, which was first put into effect in 1894, mostly as a way to help farms keep their family homesteads and make a decent living. Today it's become a boon for the middle and upper classes. Anyone who buys a house (or two) can deduct the interest payments as long as the mortgage (for one or both) doesn't add up to more than $1 million. That's a lot of subsidy. Even if someone needed that much house, does it follow that taxpayers should help him or her afford it? One suspects that without the full home-mortgage-interest deduction, some home prices might fall to where more unsubsidized folks might be able to buy them.

This is a crucial point: subsidized debt

creates inflation in asset prices. That's great for the wealthy, who own a lot of assets, and even better for their banks. But it's a strain on the Treasury and not so good for poorer, more indebted people who can be hit very hard when bubbles burst, as they inevitably do. This system subsidizes the wealthy. Nearly 90% of the value of the mortgage-interest tax subsidy goes to households making more than $75,000 a year. But even more, it rewards the financial industry itself. Financial institutions are big beneficiaries of jumbo and superjumbo loans on home mortgages, just as they are of corporate-bond deals. But they are also at risk of going under when those deals go bad.

Buffett once told me something quite relevant to our debt issues: "If you can fix housing, you can fix the economy." No wonder, then, that real estate has been at the epicenter of most financial crises over the past several decades. America still doesn't have a well-functioning real estate market. Most of the real estate recovery has been enjoyed by the rich and by investors (private-equity firm Blackstone, the largest investor landlord in the country, bought up many properties during the crisis). Politicians and the financial lobby are pushing to privatize Fannie Mae and Freddie Mac. Yet these sorts of government institutions still underwrite at least 80% of American mortgages, and it's unclear how private institutions would guarantee home loans to the vast majority of people who can't put 30% cash down on a house.

Policies that encourage people to take on more housing debt not only drive asset prices up but also create more risk in the financial system, as the subprime crisis so painfully proved. Fixing that will require changing the way Americans think about housing policy and urban development. "The biggest source of wealth in the modern economy is location-specific urban land," says Adair Turner, chairman of the Institute for New Economic Thinking and a former financial regulator in the U.K. His new book, *Between Debt and the Devil,* makes a compelling case for why debt-fueled real estate consumption is at the root of many economic problems.

Turner and others, like Nobel laureates Robert Shiller and Joseph Stiglitz, have laid out a variety of policy solutions that could help shift the dynamic, including urban-planning policies that encourage more regional development, flexible mortgage contracts in which loan payments are reduced when property prices drop and community-run housing developments that allow people to move between renting and owning as their circumstances change.

None of this will be easy, as there are deep-pocketed lobby groups that will fight to maintain the status quo. But moving from an economy fueled by debt to one powered by investment is necessary to move beyond the sluggish 2% growth of our current economy. Major financial crises happen about once every 20 years. That, at least, gives the next President some time to try to set things right before the next one hits. □