takeovers and leveraged buyouts much easier to accomplish and, thereby, may have induced an acceleration in business debt above its longer-term trend rate.

The apparent increase in debt of state and local governments since 1982 is essentially a consequence of double counting. In recent years, state and local governments have increasingly assumed the role of financial intermediaries, i.e., borrowing funds directly at tax-exempt interest rates and making the proceeds available to other borrowers (see private financiers). Late last year, the House tax bill threatened to tax interest income from state and local governments by 

90 percent of the assets acquired through financial intermediaries, such as commercial banks, the proceeds available to other borrowers. Private assets acquired through financial intermediaries, such as convenient use of credit, tax arbitrage, etc.—also accounted for the upward trend in private debt before federal debt began to balloon.

Policy Implications

When first announcing annual growth ranges for DNFD, the Federal Reserve made the distinction between monitoring ranges and target ranges. The growth range for DNFD was a monitoring range, while the growth range for money measures had typically been target ranges. This indicated that deviations in growth from the expected path would be weighed less heavily in the policymaking process than in money measures, particularly M1. In fact, with the breakdown in the relationship between money and income, the Fed has placed less reliance on M1 as a short-term guide to policy. For much of the period since 1982, no one financial measure has proved to be reliable enough to be a sole short-term policy guide.

In retrospect, the reluctance to rely much on a credit measure as a guide for short-run policy actions appears appropriate. The trend in growth of DNFD has not been followed by excessively rapid growth in nominal GNP, as would be suggested by the simple historical relationship, linking DNFD to economic activity, and strong empirical support for the framework, it seems unlikely that DNFD will provide information about the economic activity that is sufficiently reliable for predicting near-term changes in the economy.

Over a longer horizon, however, the continued trend of DNFD/GNP is likely to be associated with serious economic consequences. If debt were to continue to grow at the same pace as DNFD, then sometime early next century, the public would be forced to borrow the equivalent of the entire gross national product simply to pay the interest on the debt. In view of the longer-term concern, it seems appropriate to continue to monitor DNFD growth, despite its limitations as a short-term policy guide.

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DNFD was a reasonable variable to consider as an intermediate target for monetary policy. It also suggested that relative to money, the DNFD might be associated with steady growth in nominal GNP. This latter view is analogous to that of Friedman and Schwartz (1963), who built an extensive argument for monetarist policy to maintain the stability of the velocity of money.

Benjamin Friedman (1981) applied a variety of empirical methodologies along the lines of Friedman and Schwartz to argue the importance of money. However, it was suggested that the principles of individual behavior, and the comparison with money, the Friedman and Schwartz (1963), who along the lines of Friedman and Schwartz explained in terms of the observed stability of the DNFD-to-GNP ratio to the saving patterns. Each of these explanations relates the observed stability of the DNFD-to-income ratio to the saving patterns. Each of Friedman's three explanations suggests that the public tends to keep the private saving ratio and the amount of net debt relative to income constant. This seems reasonable because individuals ultimately own the corporations and receive the profits that arise from corporate saving. That is, the returns (to corporate investment). Consequently, individuals could view corporate saving as their own.

The “see-through-the-shell” argument is more controversial as it applies to government debt. Essentially, it is assumed that the public in some way seeks to maintain a constant level of liabilities owed relative to national income. The result is that it is the amount of private borrowing that adjusts to changes in government borrowing, not private saving. This hypothesis is in conflict with another popular hypothesis that treated the government saving variable as equivalent to private saving. The latter hypothesis presumes individuals have a strong bequest motive. If individuals save, in part, to leave wealth in the form of assets, they might save more (less) when government debt rises (falls) to offset the increased (decreased) associated with the debt. This would affect the private saving rate in a manner that would offset federal government saving. While this latter view seems to be based on principles of individual behavior, it is nevertheless inconsistent with the relationship between savings rate and the postwar period.

Friedman’s second explanation suggested that government debt growth is limited by the availability of tangible assets that provide collateral for the government debt. In this argument that individuals regard government debt (which they hold in their accounts as part of personal wealth) that, they do not associate with liability with government debt. If the government debt increased, individuals would reduce their portfolios, acquiring more tangible assets to maintain their desired savings rate. Friedman argues that the increase in tangible assets would, in turn, reduce the additional pressure against which consumers and firms could borrow. Thus, even if the government debt increased, the amount of private government debt decreased.

Friedman’s third explanation assumed that the public held both debt assets and nondebt assets in its portfolios, each in proportion to income. The government debt reduces its debt outstanding, the relative return on government securities would fall, and the individual might shift their portfolios toward private debt securities. It implicitly pre- sumes that the demand for the latter assets would increase sufficiently to add an additional supply of private debt. Friedman assumed that the decline in government debt. This also presumes that individuals do not wish to hold more tangible assets or equities as relative yields rise.

Each of Friedman’s three explanations assumes that the stability of DNFD and GNP had some plausibility until 1982. Yet each is rather ad hoc, lacking an explicit government saving variable as equivalent to private saving. The latter hypothesis presumes individuals have a strong bequest motive. If individuals save, in part, to leave wealth in the form of assets, they might save more (less) when government debt rises (falls) to offset the increased (decreased) associated with the debt. This would affect the private saving rate in a manner that would offset federal government saving. While this latter view seems to be based on principles of individual behavior, it is nevertheless inconsistent with the relationship between savings rate and the postwar period.

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