Department of Applied Economics Johns Hopkins University

Economics 602

Macroeconomic Theory and Policy

Supplement 14

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Fall 2009

The following article, which appeared in the *Wall Street Journal* on March 30, 2009, discusses nations' incentives to use inflation as a back-door way of paying for government spending. We study exactly this issue in Chapter 15.

MARCH 29, 2009,

Inflation Is Tempting for Indebted Nations

Because Rising Prices Can Ease Debt, Letting Them Climb Has Appeal to Governments Digging Deep for Stimulus Spending

By **MARK WHITEHOUSE**

LONDON -- As U.S. President Barack Obama and U.K. Prime Minister Gordon Brown seek to lead the world into battle against the financial crisis, putting up trillions of dollars to revive their economies and bail out banks, investors and other politicians are posing a troubling question: Can their governments handle the bill?

The answer, economists and analysts say, is almost certainly yes. But some offer a caveat: As the countries' debt burdens mount to levels not seen in decades, they'll ultimately face a growing temptation to allow inflation to accelerate more than they typically would -- a move that would slash the value of their debts as the prices of everything else rose.

That could cause a lot of pain for all kinds of investors, from U.S. and U.K. pensioners on fixed incomes to big holders of U.S. Treasurys such as the Chinese central bank.

"It would be epic, it would be terrible, but it's probably easier than outright defaulting," says Kenneth Rogoff, an economics professor at Harvard University and former chief economist of the International Monetary Fund.

As leaders of the world's 20 largest economies prepare for a crisis-fighting summit in London on April 2, Messrs. Obama and Brown have cast themselves as the vanguard of efforts to lift the global economy out of recession. Both have announced fiscal-stimulus packages, with the U.S. planning to spend some $787 billion. And both have turned to "quantitative easing," in which their central banks plan to print large amounts of money -- more than $1 trillion in the US, and at least £75 billion ($107.26 billion) in the U.K. -- in part to buy some of the same bonds the governments will issue to cover their gaping budget deficits.

If the stimulus measures show signs of working and preventing deflation, both the U.S. and the U.K. will face a new quandary: when and how to stop and get their budget deficits under control.

If they wait too long, they could launch an upward spiral of prices as too much stimulus money chases the same goods and labor -- a possibility that has recently raised increasing concern. Last week, Czech Prime Minister Mirek Topolanek, before resigning Thursday after an earlier no-confidence vote, echoed complaints from other European leaders when he called the U.S. spending plans the "road to hell." Meanwhile, poor demand at a U.S. government bond auction and the failure of a separate auction in the U.K. added to unease about the market's willingness to support the countries' heavy borrowing.

Some analysts have gone so far as to conjure up images of Germany in the 1920s or Zimbabwe in the 2000s, where the printing of money to cover chronic deficit spending debased currencies and bred hyperinflation. "Horror stories about how hyperinflation starts are going to be surfacing again," says Jan Loeys, global market strategist at JPMorgan Chase & Co. in London. "Investors are getting worried."

Most economists and analysts say that in the case of the U.S. and U.K., that kind of doomsday scenario is extremely unlikely. While they believe policy makers will prefer to err on the side of inflation, they don't expect it to get out of control. Heavy borrowing could boost both governments' net debt to nearly 100% of the nations' annual economic output, but that's still less than Japan, which so far hasn't had trouble issuing bonds despite its lower credit rating. At the right price, both countries' bonds have a lot of natural buyers, such as pension funds that need to lock in payments stretching far into the future.

More pernicious, though, will be the political cost of making the interest payments on all the new debt. If interest rates rise to a moderate level, economists estimate that annual debt payments could reach 4% of GDP, an amount roughly equivalent to the entire U.S. military budget, forcing tough decisions on what else to cut.

The debt-service burden could be even more troublesome in the U.K., which faces the prospect of sharp budget cuts and higher taxes after years of depending on the finance sector for much of its tax revenue.

The pressure of the debt payments has the potential to alter policy makers' attitude toward inflation. Typically, central bankers seek at all costs to keep inflation in check, because they see it as an inequitable tax that erodes the buying power of a country's currency and people's savings.

But in a country with heavy debts -- households in the U.S. and the U.K. are the world's most indebted -- the equation changes: Inflation can reduce the burden, because the face value of bonds and mortgage debts stay the same, while things like nominal wages, tax revenues and house prices tend to rise.

"The political economy of inflation in this situation might not be as clear-cut as it is in normal times," says Pierre-Olivier Gourinchas, an economics professor at the University of California, Berkeley.

Mr. Rogoff says annual inflation could go as high as 8% to 10% within three to five years in the U.S., and sooner in the U.K. That can have a big impact on bond prices. If, for example, investors expected U.S. inflation to rise to 8% to 10% a year, the price of the 10-year U.S. Treasury bond would have to be about 25% lower than it is now.

Investors' concerns about inflation have risen in recent days, but remain subdued. As of Friday, investors in interest-rate markets were betting that the average inflation rate over the next ten years will be about 2.6% in the U.S. and 3.4% in the U.K. That was up from about 2.0% and 3.1% a month ago, respectively, according to Mark Schofield, global head of interest-rate strategy at Citigroup Inc. in London.

If investors remain relatively sanguine, says Mr. Rogoff, it could make the inflation route more attractive for policy makers, allowing them to sell government bonds for a high price, then inflate the debts away.

"All the elements are in place to pull the rug out from under investors," he says.

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