Avoiding inflation will require tough choices

Policy makers have responded to successive economic downturns in essentially the same Keynesian way since the 1950's. Fiscal deficits have been allowed to rise and interest rates to fall to stimulate aggregate demand, and these policies worked. As a result, the policy response to the current crisis has been "more of the same". Many policymakers remain confident that this will eventually generate a sustained recovery. However, it is also worth reflecting on why it might not work this time and, if so, whether Plan B involves more inflation?

An unsustainable level of private sector debt is the main factor explaining the present severe downturn, as well as many previous downturns in history. Today, the problem principally resides in the household sector in many advanced market economies. In Japan in the 1980's corporations went on a similar spree of spending which was almost wholly funded by debt. However, the problem with debt is that it constitutes a claim on future earnings, which cannot be met if earnings expectations fail to materialize. When this happens, as it often does, the stage is set for a severe economic slowdown.

Although debt problems traditionally originate in the private sector, the public sector cannot be held blameless. Today's unsustainable debt levels have much to do with the repeated use of monetary easing to stimulate consumer demand in successive cycles. The repeated use of fiscal measures to support demand made private debt more supportable, but at the same time increased public debt levels. With respect to both monetary and fiscal policy, tightening in the cyclical upturns never matched the vigor of the easing in the downturns.

Such historical reflections also explain why both monetary and fiscal policies have reached the limits of their effectiveness. As to monetary policy, interest rates ratcheted down and are now essentially at zero. As to fiscal policy, worries about the sustainability of public sector debt have caused sovereign rates to rise sharply in some smaller countries, and other bigger countries might follow. Faced with the prospects of a rising sovereign risk premium, fiscal easing could prove less supportive of growth than fiscal tightening.

Suppose that the repeated asymmetric use of macro policies has rendered them ineffective. What other policy measures might then help deal with the debt "headwinds" problem? Two possibilities suggest themselves.

One possibility would be to make existing debt levels more sustainable. Encouraging an orderly deleveraging of balance sheets, both household and financial, is one route. However, an obvious problem is that, as saving rates rise, multiplier and accelerator effects might interact to produce a deeper recession than anticipated. Another way to raise debt service capacities would be to increase potential growth through structural reforms. At best, however, both routes would produce many years of very slow growth.

A faster, but initially much more painful, way to make debt levels more sustainable is to reduce them through bankruptcies or negotiated workouts. Evidently, this might require the restructuring and recapitalization of lending institutions as well. Again, there are obvious difficulties, not least in the United States where debt problems affects many millions of households. In addition, justifiable concerns would be raised about the short term costs of higher unemployment, moral hazard, and property rights. Many countries also lack an adequate legal framework to facilitate such measures, particularly for financial institutions. Policy makers should make far greater efforts than they currently do to remove unnecessary impediments to an orderly writing down of debt.

Economics is often about hard choices. If the headwinds of debt have overwhelmed the capacity of macro policies to stimulate real growth, then other more structural, but inherently more difficult, measures ought to be turned to. However, if there is not sufficient political will to do so, then the probability grows that policymakers will search for an inflationary solution to the debt problem. This likelihood is increased in the United State by the growing pressure being put on the Fed by both Congress and the Treasury, and by the recognition that much of US debt (both private and public) is denominated in US dollars and held by foreigners. There are many historical examples to prove that debts can be inflated away, though few that stopped short of hyperinflation. Why take this very risky path when there are less dangerous, albeit still difficult, paths to follow?