Comment on Eric Leeper and Todd Walker, “ Perceptions and Misperceptions of Fiscal Inflation”

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Introduction

- This useful paper identifies the fiscal pitfalls that loom on the horizon after the recent crisis.
- Run ups in fiscal deficits and debt ratios after the crisis on top of future entitlements leads to risk of inflation despite central banks good intentions.

Introduction

- The framework followed is based on the Fiscal Theory of the Price level.
- In normal times the independent central bank follows a credible inflation target – “active monetary policy”.
- The fiscal authority follows passive policy— is expected to offset present fiscal deficits with future surpluses.

Introduction

- In times of fiscal stress like today there is a possibility(e.g. for political reasons) that taxes will not be raised or expenditures cut sufficiently to fully offset present deficits.
- In that situation of active fiscal policy, monetary policy will become passive.
- Agents will perceive the increase in nominal debt to be an increase in real wealth.

Introduction

- They will increase consumption expenditure and bid up the price level.
- Higher prices will reduce the real value of the debt and restore fiscal equilibrium.

Weimar Germany as an analogy to the present U.S. situation

- The authors view the fiscal situation in Weimar Germany as a good analogy for the present .
- The fiscal problem facing Germany in the early 1920s was how to fund the increase in the fiscal deficit produced by the reparations under the Versailles Treaty.
- The reparations were payable in gold marks while tax revenues were in paper marks.
- The inability (unwillingness) to raise taxes sufficiently to pay the reparations meant that according to the fiscal theory that prices would have to rise.

Weimar Germany

- Rising prices and falling exchange rates led to an explosion in the debt.
- The resulting hyperinflation in 1923 reflected a stalemate between France and Germany over the pace and timing of reparations.
- It also reflected political chaos within Germany.
- These factors impeded a solution to the fiscal impasse.
- The authors see a similarity between these historic events and the present impasse in the U.S. over the growth of future entitlements.

Weimar Germany

- The comparison between the U.S. today and 1920s Germany seems too extreme to be useful.
- The political environment in Germany involved open civil war between the communists and the far right and then the occupation of the Ruhr by the French.
- This was infinitely worse than today's bickering between the Tea party and the liberal democrats.

Weimar Germany

- Also economic disruption in Germany was far worse than the recession of 2007-2009.
- Moreover in the German case external debt was payable in a foreign currency – a major source of financial crisis for emerging countries.
- In the US the debt is in domestic currency and the dollar is the dominant international currency

France in the 1920s

- The experience of France in the 1920s is much more compelling than that of Germany as an historical example to illustrate the pitfalls of rising debt.
- The political situation in France was not nearly as dire as in Germany.
- French debt was denominated in local currency.
- The fiscal crisis that occurred did not lead to hyperinflation.

France in the 1920s

- The French situation after World War I, in comparison to that of Britain has all the elements of the authors story of active versus passive monetary and fiscal policies. (Bordo and Hautcoeur 2007).
- The British experience was characterized by active monetary and passive fiscal policy.
- The French case was the opposite.

France in the 1920s

- Both countries emerged from World War I with more than a doubled price level (figure 1), a high ratio of debt to GDP (figure 2), large fiscal deficits (figure 3) and a depreciated exchange rate (figure 4).

France in the 1920s

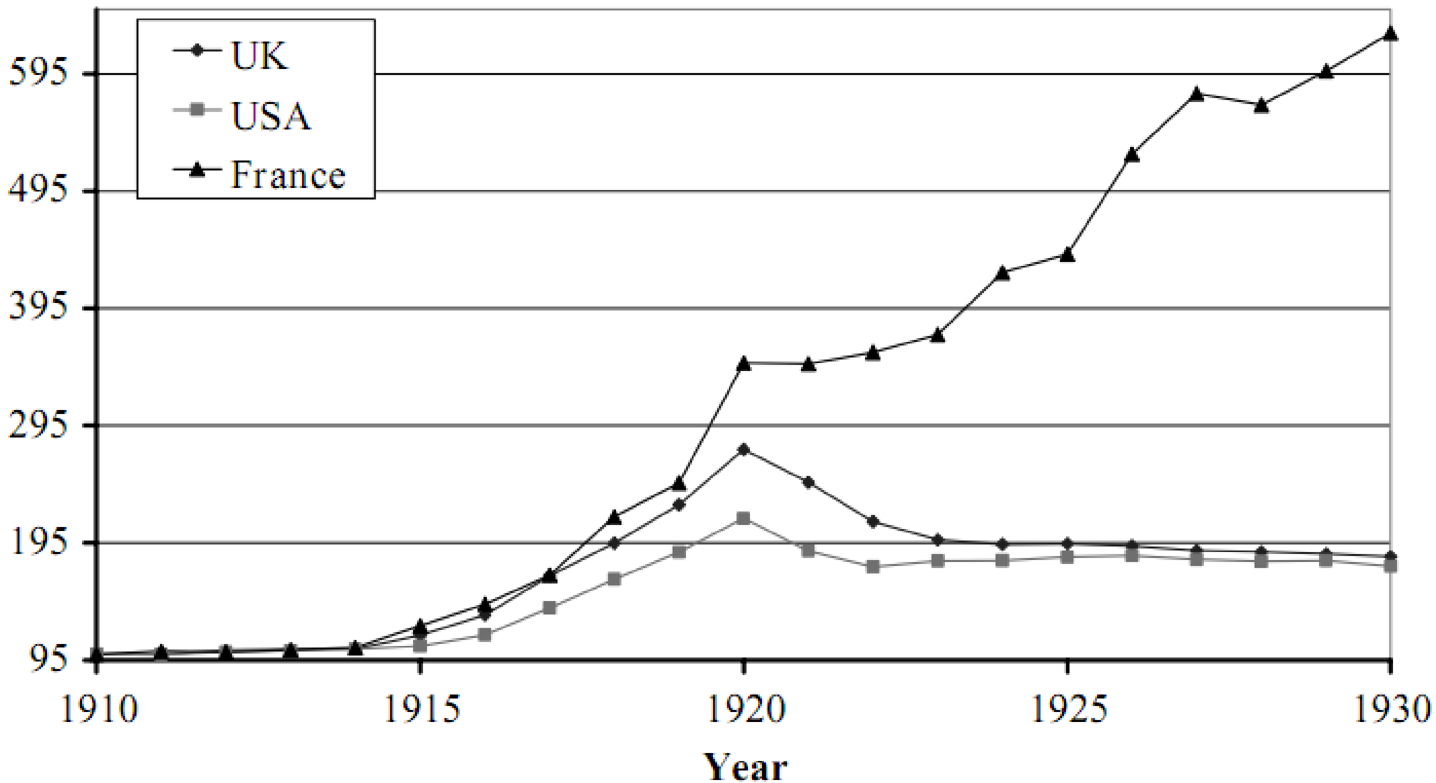
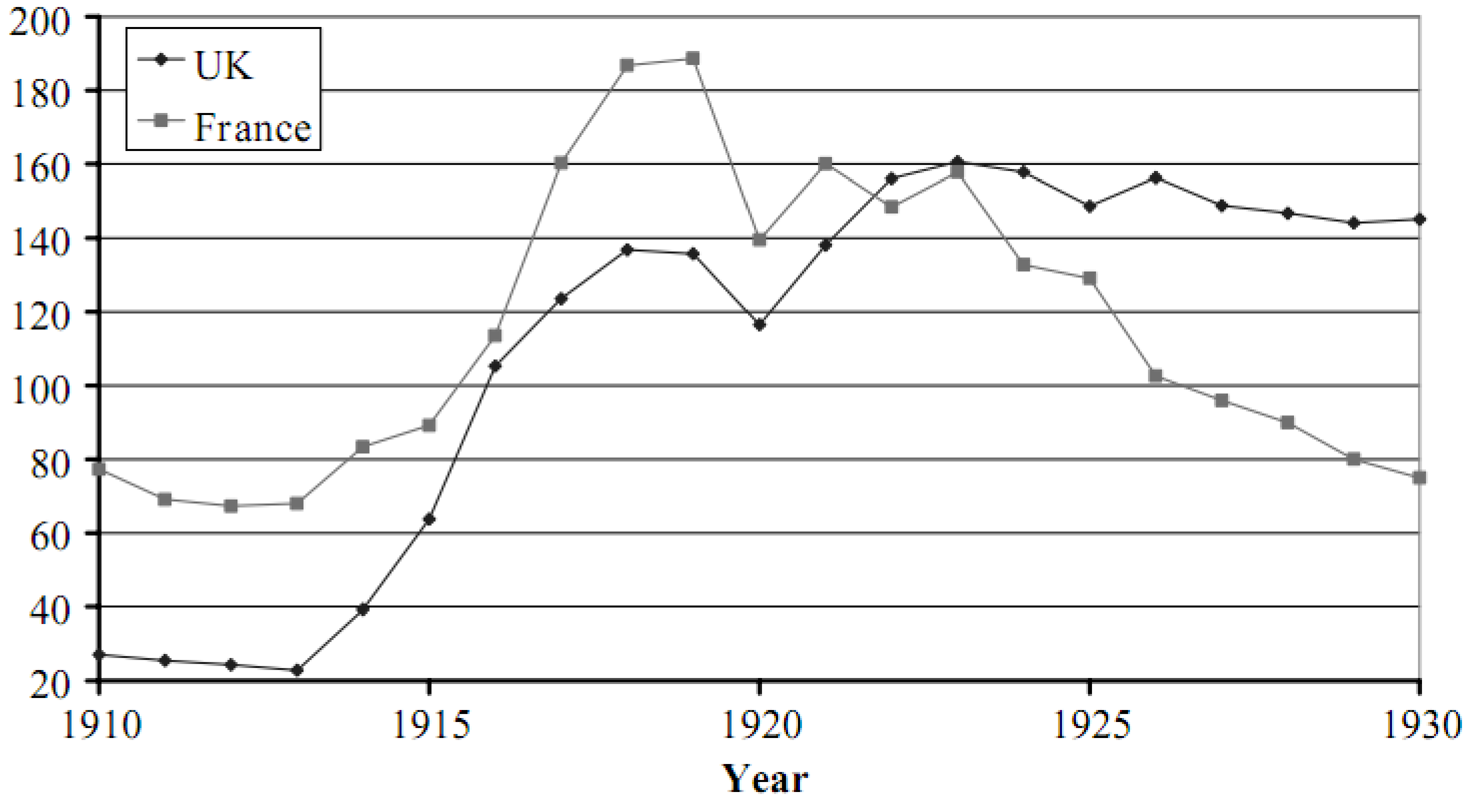
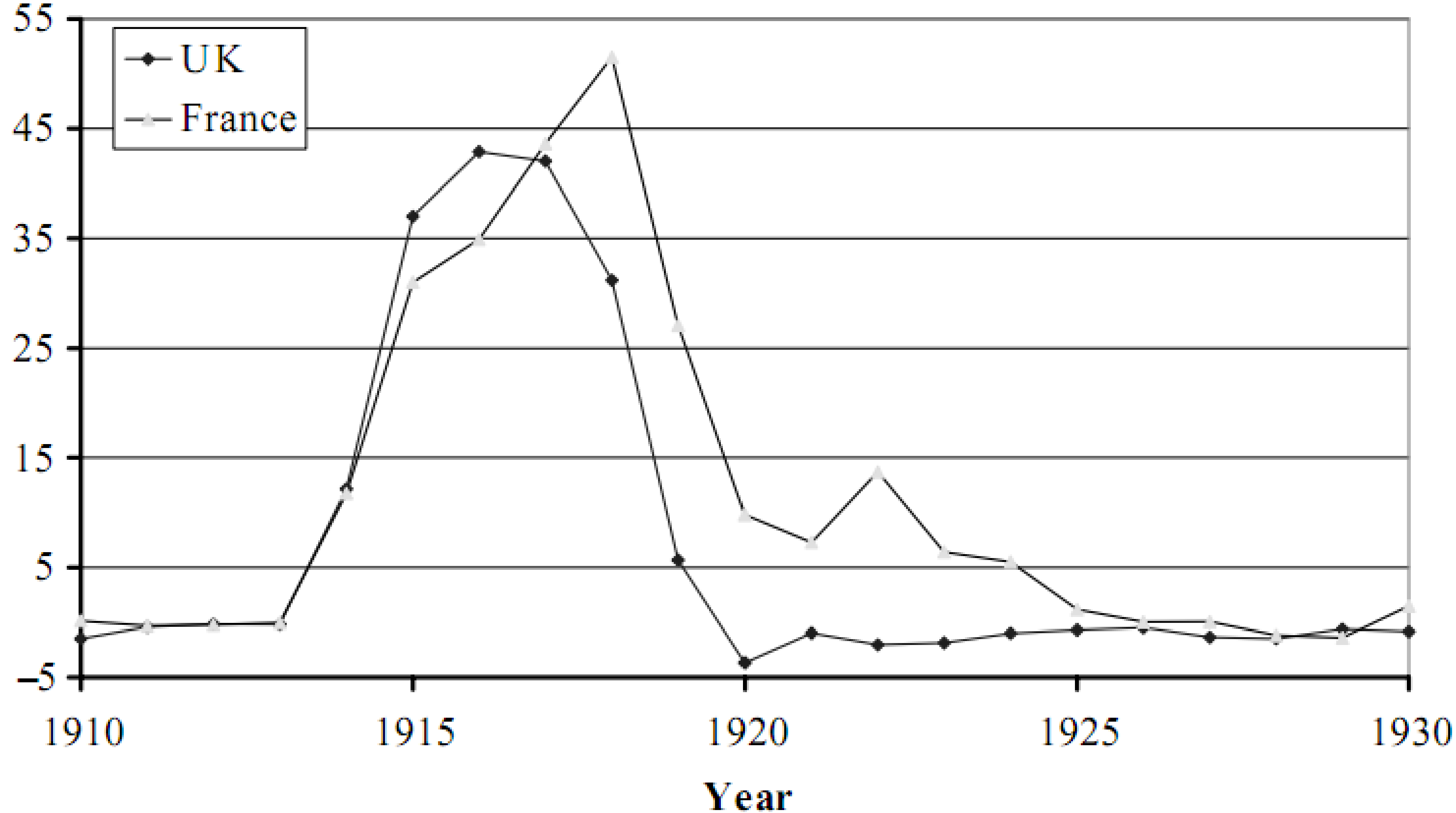


Figure 1. *Price level (1910 = 100).*

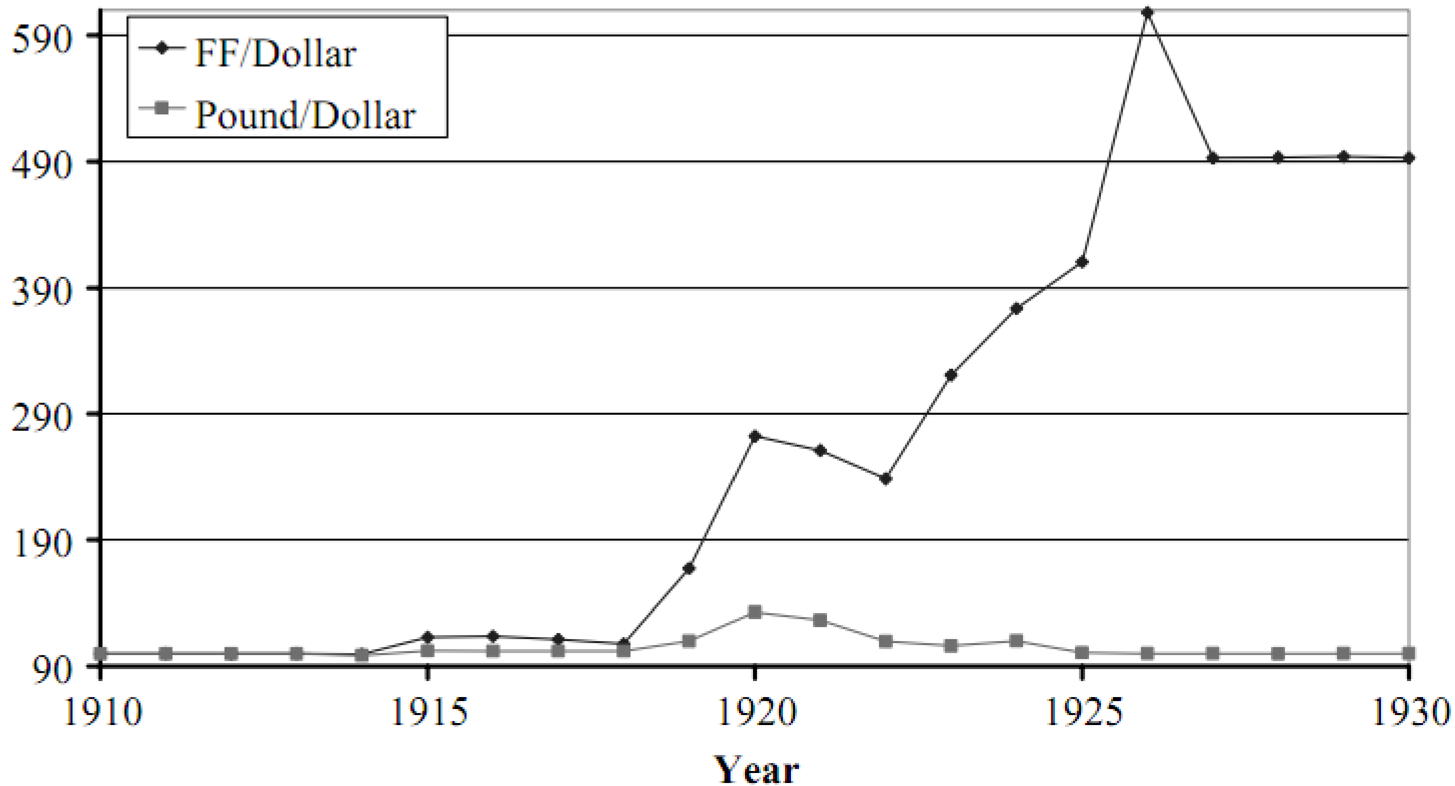
France in the 1920s – Debt to GDP



France in the 1920s – Budget Deficit (% of GDP)



France in the 1920s – Nominal Exchange Rate



France in the 1920s

- France was in worse shape than Britain in all dimensions but not by much.
- Basically France had a worse fiscal and monetary stance than Britain.
- France had a higher debt ratio, more short-term debt and a big monetary overhang.
- The British pulled off a successful fiscal stabilization and returned to gold at the original parity in April 1925.

France in the 1920s

- France stabilized much later and returned to gold at a greatly devalued parity in December 1926.
- France had six years of rapidly rising prices and as in the Leeper and Todd model, the rise in the price level reduced the real value of national debt.
- Fiscal balance was restored in 1926 by a political compromise between the left and the right.
- This involved both raising taxes and reduced government expenditure.

France in the 1920s

- The French problems are well known (Eichengreen 1992)
- -First, France ran larger deficits in WWI . The central bank absorbed short-term T bills and pegged short-term rates, ie ran a passive monetary policy.
- -Second. France lacked the political commitment to stabilization and resumption that the British had.

France in the 1920s

- This reflected:
- a) reparations—the belief that the Germans would pay;
- b)a struggle between left and right over who would cover the deficit once it became apparent that the Germans wouldn't pay. The left wanted a capital levy , the right wanted to raise taxes.
- c)The Banque de France absorbed more of the short-term debt than the Bank of England and had a larger monetary overhang, and the government would have to repay its short-term debt to the Banque which would raise the deficit and the debt.

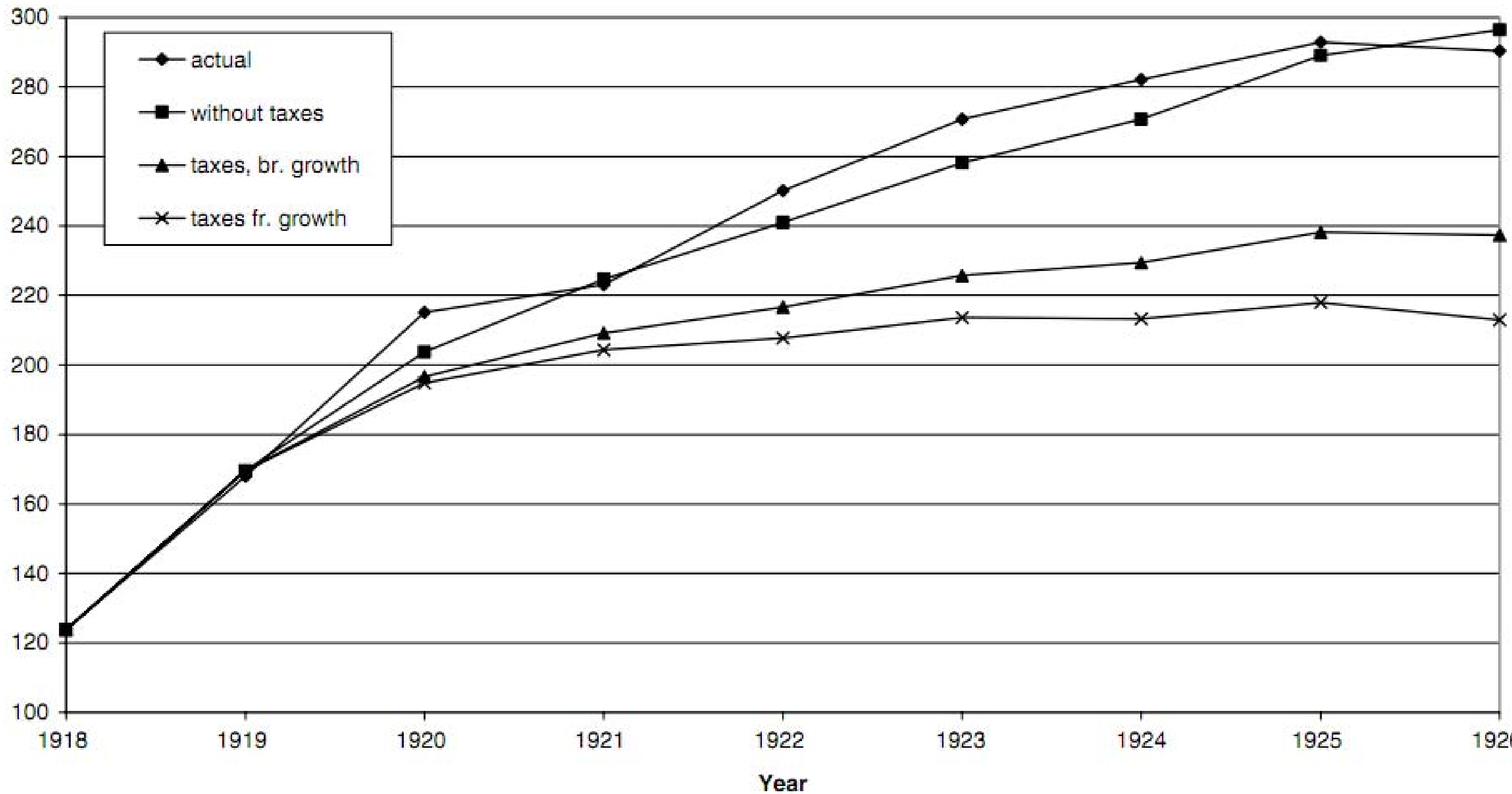
France in the 1920s

- The political tug of war continued for 7 years.
- Instead of cutting expenditures and raising taxes the government issued short term bills which were largely absorbed by the Banque de France leading to inflation and a depreciating exchange rate.
- Fiscal equilibrium was reached in 1926 when Raymond Poincare was able to raise taxes, cut spending and borrow from JP Morgan.
- The funds were used to stabilize the franc.
- The franc was pegged to gold at an 80% devalued rate in December 1926.

France in the 1920s

- Bordo and Hautcoeur(2007) simulate a model of the French economy in the 1920s.
- We show that it was impossible for France to engineer a British style stabilization and resumption.
- British style debt consolidation and deflation would have increased French nominal debt to unsustainable levels.

France in the 1920s – Nominal Public Debt



France in the 1920s

- France would have had to have a huge increase in the price level and a major devaluation to achieve fiscal equilibrium

Lessons from the French experience in the 20s for the U.S. today

- First, if the U.S. debt ratio gets high enough then a rising price level is pretty likely.
- Second, however a political deal is a good possibility before such an outcome were to be reached.
- Other advanced countries in the recent past have worked out such deals without having inflation, eg Canada in the 1990s.

Lessons for Today

- But the U.S. experience after World War II suggests the inflation outcome.
- The debt ratio in 1945 was close to 120%.
- It was largely inflated away in the next two decades.
- Achieving such an outcome today might be more difficult because much of U.S. debt is held abroad and significant inflation would threaten the dollar's" exorbitant privilege" (Eichengreen 2010)

Lessons from the 1920s

- Third, a deal may be worked out sooner rather than later because of the threat to the dollar's international position.
- The exchange rate is a forward looking variable which could quickly telescope a future fiscal impasse to the present.
- A dollar crisis in 1978 triggered President Carter's appointment of Paul Volcker in 1979 to engineer his famous shock which ended the Great inflation.
- A similar fiscal event could happen in the not too distant future.