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

Eric Leeper and Todd Walker have written a very useful paper to identify the fiscal pitfalls in the aftermath of the Financial Crisis of 2007-2008 and the Great Recession that could undermine the conventional paradigm of an independent central bank following a credible rule to maintain low inflation. Big run ups in fiscal deficits and debt to GDP ratios in the US and other advanced countries after the Great Recession on top of the expenses of future entitlements leads to the risk that inflation will rise despite central banks good intentions to avoid it.

The authors' argument is based on the Fiscal theory of the price level. According to that framework, normal times are characterized by the central bank pursuing active monetary policy combined with passive fiscal policy. In that environment the central bank follows its low inflation target independent of the actions of the fiscal authority. The fiscal authority is expected to fully offset fiscal deficits today with surpluses in the future. In times of fiscal stress like the present, there is a possibility(for political or other reasons) that taxes will not be raised or expenditures cut sufficiently in the future to prevent the national debt from ballooning. In that situation according to the authors ' framework, fiscal policy will become active and monetary policy passive, also referred to as a situation of fiscal dominance. I Economic agents will perceive the increase in nominal debt to be an increase in their real wealth , leading them to increase their consumption expenditures and hence raising the price level. Higher prices will reduce the real value of the national debt and restore fiscal equilibrium.

The authors view the situation in Weimar Germany in the early 1920s as a good example of fiscal dominance creating inflation which they argue has some resonance for the situation facing the U.S. at present.

The fiscal problem facing Germany after its defeat in World War I was its inability to fund the increase in its deficit produced by the demands of the Treaty of Versailles reparations, payable principally to France and Belgium. The reparations were payable in gold marks and dollars (denominated in gold) and tax revenues were collectible in paper marks. The inability (unwillingness) to raise taxes sufficiently or to borrow the funds to pay the reparations abroad (as was done earlier in 1871 after France's defeat by Germany in the Franco Prussian War) meant that the fiscal deficits would have to be monetized(in the conventional lexicon) or in terms of the fiscal theory --that the price level would have to rise . Rising prices and falling exchange rates led to a burgeoning fiscal deficit and an explosion in nominal debt. The resulting hyperinflation reflected both a stalemate between France and Germany over the pace and timing of reparations and political chaos within Germany which impeded a solution to the fiscal impasse. The authors argue that there is a similarity between these historic events and the present impasse in the U.S. over reducing the growth of future entitlements, which according to various estimates, will also produce a debt explosion and, based on the fiscal theory of the price level will lead to inflation even if the Fed sticks to its inflation fighting principles.

The comparison between the experience of Germany in the 1920s and the U.S. today seems to be too extreme to be very useful. The political environment in Germany after World War I, involving open civil war between the communists and the extreme right and then the occupation of the Ruhr by the French was infinitely worse than today's bickering between the Republican Tea party and the liberal Democrats, and the postwar economic disruption in Germany after the war seems very far removed from the aftermath today of a recession which compared to earlier recessions in the twentieth century was relatively mild. Moreover the fact that reparations were payable in gold, i.e. that external debt was payable in a foreign currency, is a major source of crisis instability for emerging countries but not at present for the U.S. which is still the dominant international currency and all of US national debt is denominated in dollars.

The experience of France in the 1920s seems to me much more compelling than that of Germany as an historical example to illustrate the pitfalls of rising debt. This is because the political situation in France was not nearly as dire as in Germany , the French economy was in better shape, French debt was denominated in local currency, and the fiscal crisis that occurred did not lead to a hyperinflation. The French situation after World War I , in comparison to that of Great Britain(Bordo and Hautcoeur 2007) has all the elements of the authors' story of active versus passive monetary and fiscal policies. The British experience could be characterized by active monetary and passive fiscal policies whereas the French case was the opposite. Both countries emerged from World War I with more than a doubled price level (see figure 1), a high ratio of debt to GDP(figure 2), large fiscal deficits(figure 3) and a devalued exchange rate (figure 4). France was in worse shape than Britain in all dimensions but not by much. The key difference between the two countries was in their fiscal and monetary stances after the war. France had a higher debt ratio, more short-term debt and a big monetary overhang. France had extensive destruction of its physical capital stock but also a faster growth rate than Britain.

The British were able to pull off a successful stabilization and resumption to the gold standard at the original parity beginning in 1919 and culminating in April 1925. The French stabilized later and went back to gold in December 1926 with an 80% depreciation in the franc. More important, France had 6 years of rapidly rising prices and, as in the Leeper and Todd model, the rise in the price level reduced the real value of the national debt. Fiscal balance was restored in 1926 by a political compromise between the left and the right involving both rising taxes and reduced government expenditure.

The French fiscal problems in the 1920s are well known (Eichengreen 1992). First , like Britain, France financed World War I with a combination of taxes, debt and seigniorage, but France didn't raise taxes as much so that the deficit and debt was higher(see figures 2 and 3). In both countries the central bank absorbed short-term Treasury bills and pegged short-term interest rates.

Second, France, unlike Britain didn't have the political commitment to stabilization and resumption that the British did. There were three issues: a)reparations—the belief that German reparations would pay for reconstruction; b) a struggle between the left and the right over who would cover the fiscal deficit once it became apparent that the Germans would not pay. The left wanted to impose a capital levy and the right wanted to raise excise and other taxes; c) The French had monetized more of their short-term debt than did the British and consequently had a larger monetary overhang which required more deflation to get back to the pre war gold parity. Moreover the government had to repay its short-term debt to the Banque de France which in turn would raise the deficit and the debt .

The political tug of war continued for 7 years with several changes of government and many finance ministers. Instead of raising taxes and cutting expenditures sufficiently to balance the budget, the government kept issuing short-term bills which they had difficulty selling and rolling over and hence they were absorbed by the (passive) Banque de France leading to inflation and a depreciating exchange rate.

An equilibrium which solved the political impasse was finally achieved in July 1926 when a revolt by left-wing deputies in Parliament led to an invitation to Raymond Poincare(center right) to take over the government and to rule by decree. He raised taxes, cut expenditures and was able to borrow dollars from JP Morgan and Lazards and use the funds to conduct a bear squeeze on speculators selling francs short. This stabilized the franc which was then pegged to gold at a greatly depreciated rate in December.

Bordo and Hautcoeur (2007) simulate a model of the French economy in the 1920s and show that it was impossible for France to engineer a British style stabilization and resumption. This is because following the British route of consolidating debt and deflation would have increased French nominal debt to unsustainable levels. See figure 5. This suggests that France had to have a huge increase in the price level and a major devaluation to achieve fiscal equilibrium. We also show that economic circumstances could have allowed a stabilization two years earlier, in early 1924 when an earlier Poincare government was in power, with a much smaller devaluation and less inflation than ultimately occurred. It did not happen because Poincare lost the election in the spring and it became impossible to work out such a deal.

There are a number of implications from the French example for the U.S. case today.

First, if the debt ratio gets high enough, then as the authors posit a rise in the price level is pretty likely.

Second however a political deal is a good possibility before such an outcome, as occurred in France, were to be reached. Other advanced countries in the recent past have worked out such deals without having inflation, for example Canada in the 1990s and the U.S. in the same decade. But U.S. history following 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 a similar outcome today might be more difficult to do because much of the debt is held abroad and significant inflation would threaten the dollar's international currency status. Moreover the debt is of much shorter maturity which reduces the debt reduction ability of inflation (Aizenman and Marion 2010).

Third, a deal may be worked out sooner rather than later because of a potential threat to the dollar's "exorbitant privilege" and the losses that would entail for the U.S. economy (Eichengreen 2010). 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.

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References

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Appendix – figures

Figure 1

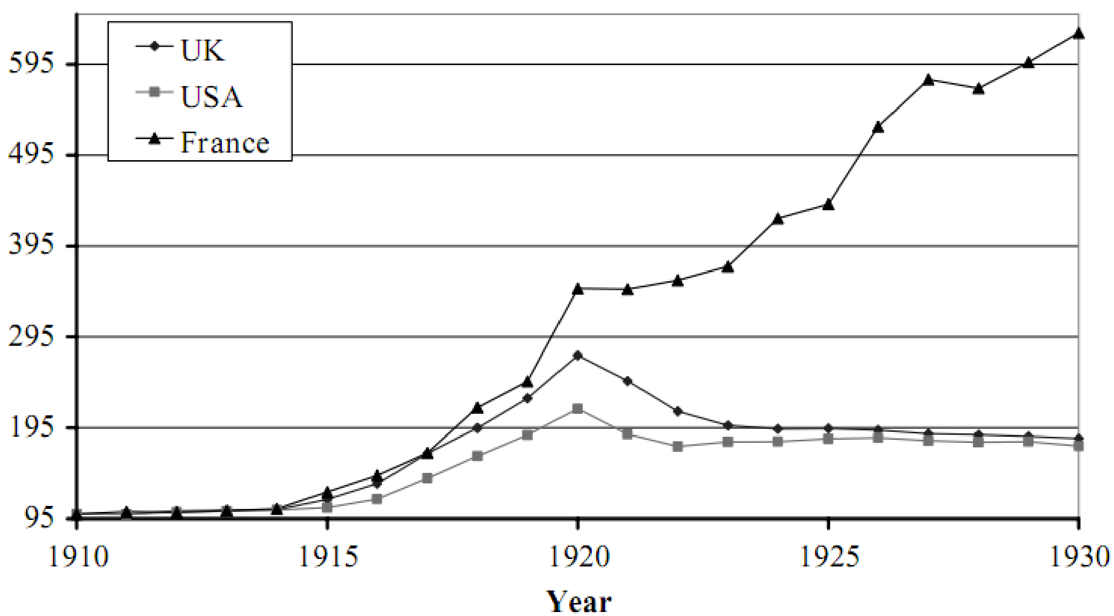

Figure 1. *Price level (1910 = 100).*

Figure 2 – Debt to GDP

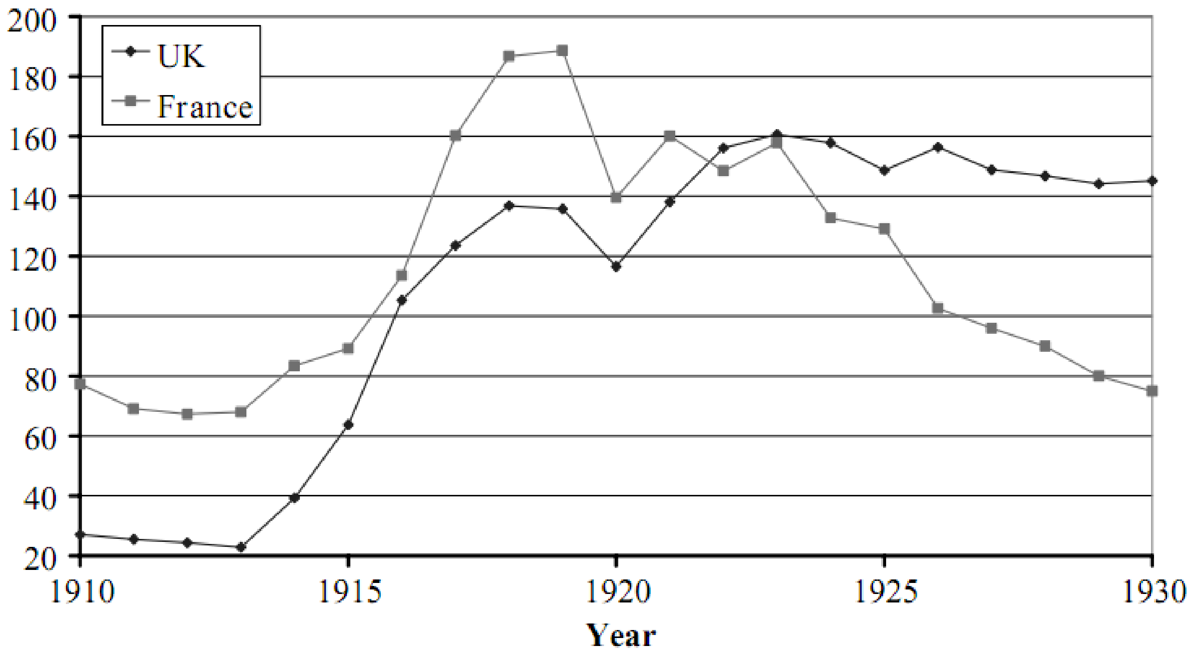

Figure 3 - Budget Deficit (% of GDP)

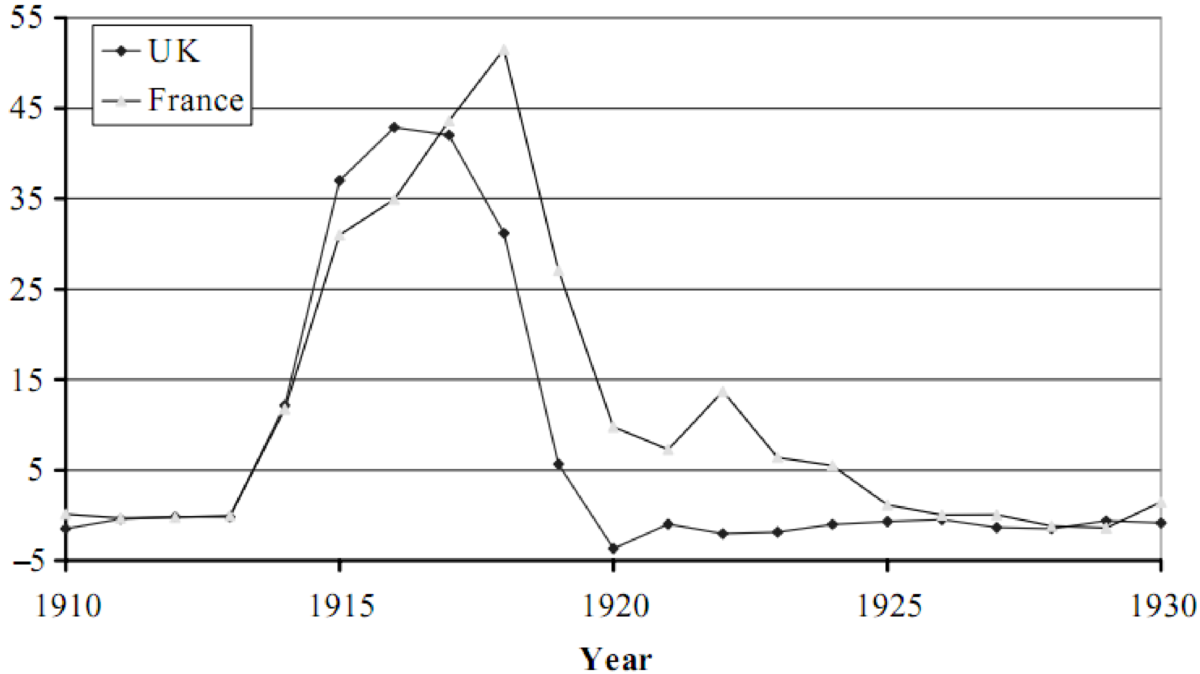

Figure 4 – Nominal Exchange Rate

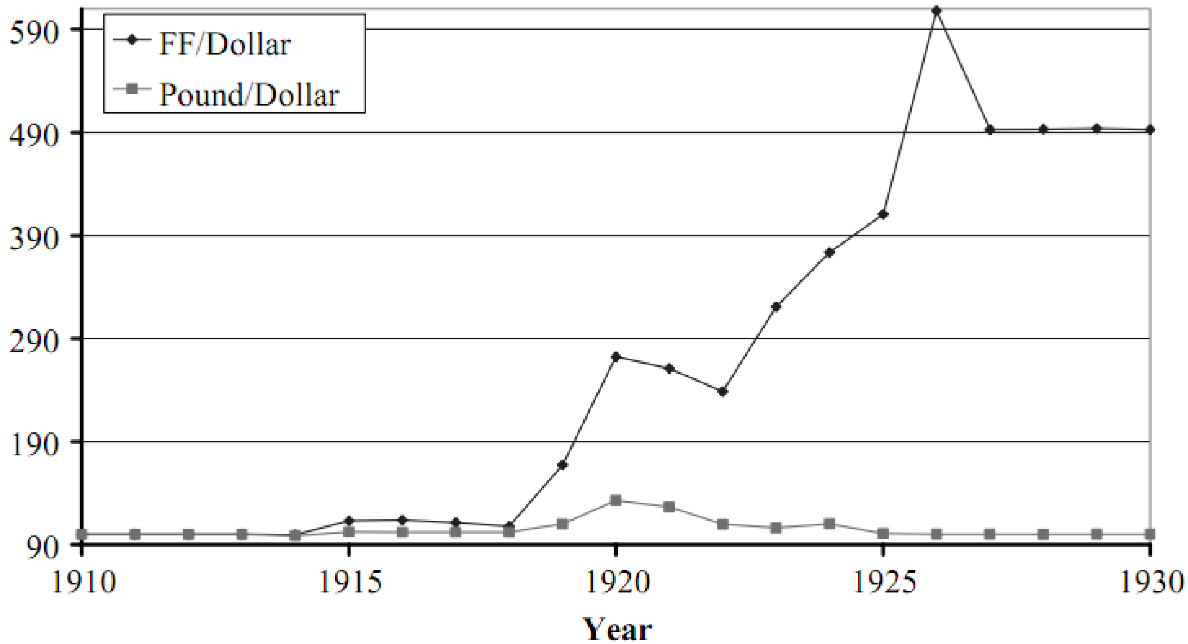

Figure 5 - Nominal Public Debt