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Low inflation and **rising global debt**: just a coincidence?

At first sight, they seem unrelated. After all, why should low inflation and rising debt be linked? True, from the early 1980s inflation declined, and then stayed quite low in much of the world while debt (private plus public) in relation to GDP rose to new peaks. But is this not just a coincidence? Maybe. On reflection, though, the link may be much tighter than we think. To understand why, we need to travel back in time. Not too far, but some distance nonetheless.

I-Exploring the link

It probably all started some 30 years ago. The change did not come suddenly, but slowly and cumulatively, as events unfolded. It was not a development on the surface, but something much deeper, like the adjustment of tectonic plates. Nor was it a single force, but three that eventually came together. Each of them, taken in isolation, was, and is, highly beneficial. All of them, in isolation and as a package, were, and are, precious and worth safeguarding. Taken together, though, they arguably changed the workings of the world economy in subtle and unexpected ways, throwing up new challenges from unsuspected quarters. And policies did not adjust.

The changes engulfed financial, monetary and real-economy regimes

The first change was financial liberalisation, both domestically and across borders began in earnest in advanced economies in the early 1980s, and by the early 1990s was largely complete around the world. To use Padoa-Schioppa and Saccomanni's felicitous phrase, liberalisation turned an essentially government-led into a market-led financial system.

Financial liberalisation was a welcome change after the financial repression that had preceded it. But it also gave full play to the self-reinforcing interaction between loosely anchored perceptions of value (wealth) and risk, on the one hand, and funding conditions ("liquidity"), on the other. This amplified and lengthened financial cycles, the most disruptive of which typically take the form of outsize expansions and contractions in credit and asset prices, most notably property prices, and can spread across borders through flighty capital flows, often denominated in the world's dominant currency – the dollar. More than just metaphorically, we shifted from a cash flow-constrained to an asset-backed global economy.

The second change was the adoption of credible anti-inflation monetary policy regimes. Paul Volcker led the way in the early 1980s, and by the 1990s the inflation dragon had been slayed around much of the world. In particular, as the 1990s unfolded, more and more central banks adopted inflation targeting regimes, seeking to steer inflation typically over horizons of one to two years. These frameworks paid little attention to the monetary and credit aggregates that had often guided policy in the early phases of the battle against inflation: these variables had become progressively less useful. And as the frameworks proved successful, they became increasingly ambitious, seeking to steer inflation within narrower margins.

Conquering inflation was a major achievement. Inflation had wreaked havoc with the economy and had eroded society's fabric. But the new regimes offered little resistance to the build-up of financial imbalances. History indicates that financial imbalances have often built up even in the context of low and stable inflation, sometimes also of falling prices. This was not uncommon under the gold standard, for instance – the previous globalisation wave. But it has also been quite common since the 1990s. Thus, as long as inflation did not pose a problem during financial expansions, there was little reason to tighten policy, especially since monetary and credit aggregates had been put to one side. There is a kind of "credibility paradox" here: anti-inflation credibility arguably made it less likely that signs of unsustainable economic expansions showed up first in rising inflation and more likely that they emerged first as outsize financial expansions.

Globalisation of the real side of the economy

The third change was the globalisation of the real side of the economy. Globalisation came into its own in the early 1990s and gathered pace in the early 2000s. It followed on the heels of the entry into the world's trading system of former communist countries and China as well as of the opening-up of emerging market economies (EMEs), notably India. This added something like 1.6 billion people to the global labour force. Alongside the expansion of global value chains, it amounted to a string of positive supply side shocks, which raised the world's

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growth potential and sharpened competition. Unleashing the global economy's growth potential helped lift large parts the world's population out of poverty. But the new regime provided additional fuel for the emergence of outsize financial expansions, sustained by overly optimistic growth expectations – what Kindleberger would call "displacement" – as well as persistent disinflationary pressures. Central banks' fight against inflation received unexpected support.

All this helps explain the low inflation. But financial cycles, by definition, involve both expansions and contractions. How could this then help explain the increase in global debt, public and private, that we have seen at least since the early 1980s? The answer is a ratchet effect. The effect arises because financial busts, especially if they go hand in hand with banking crises, leave very long-lasting scars on the economy: output may be permanently lower relative to its previous trend. Thus, the impact of financial cycles is not symmetric. More importantly perhaps, policy responses may not be symmetric either. This ratchet effect has arguably reinforced other, better known forces: the turbo-charged financial deepening linked to financial liberalisation and the inherent political difficulties in keeping public finances under control, themselves under growing strain from demographic pressures.

Let's consider the role of policy in more detail

Fiscal policy has typically been asymmetric. The authorities have failed to recognise that financial booms hugely flatter the fiscal accounts. Potential output and growth are overestimated, financial expansions are revenue-rich, and resources may be needed to repair banking systems when a crisis occurs. The long-lasting impact of the busts on output and productivity does the rest. The experience of Spain and Ireland is quite telling. Public debt relative to GDP actually declined in the run-up to the Great Financial Crisis (GFC), and observers thought the countries were running cyclically adjusted fiscal surpluses. These purported role models of fiscal probity then faced a sovereign crisis once the financial cycle turned and their banks ran into serious trouble.

Monetary policy has, unwittingly, been somewhat asymmetric too. In the context of low and stable inflation during financial expansions, there has been no reason to tighten. But the financial bust-induced damage, coupled with concerns about a deflation threat, has naturally led to protracted easing to steer the economy back towards full capacity and push inflation up. The persistent disinflationary pressures linked to globalisation and, increasingly, technology reinforced the trend towards lower rates: the tailwinds that had helped central banks in the run-up to the GFC turned into powerful headwinds in its aftermath. Bringing inflation back to target has proved much harder than initially thought.

Over successive business and financial cycles, all this can contribute to an upward drift in debt levels (Graph). Unless corrected, public finances deteriorate. And monetary policy contributes to a downward trend in interest rates which boosts debt further. The risk of a "debt trap" can become real: the rise in debt makes it harder to raise interest rates towards more normal levels without generating the problems policymakers are trying to avoid. The economy becomes more sensitive to interest rate increases, not least because of their stronger impact on debt service burdens.

The limitations of the current vintage of macroeconomic models complicate the incorporation of such effects in policymaking. Such effects are simply absent. The models are deficient in dealing with stocks and eschew disequilibrium or unsustainable trajectories. The economy invariably returns rather swiftly to "steady state" after being hit by unforecastable, exogenous shocks. Meaningful financial cycles are not present. And the ratio of debt to GDP does not get out of control.

Developments around the GFC are consistent with the picture painted here. Central banks had no reason to significantly raise interest rates in the run-up. Once the financial boom turned to bust, they naturally pulled out all the stops to support the economy, just as public finances came under serious strain. Central banks' concerted efforts arguably avoided a repeat of the Great Depression. Moreover, their subsequent, very accommodative stance helped lay the basis for the global economy's recovery while contributing to the gradual convergence of inflation towards objectives. Still, with the burden of the recovery largely on central banks' shoulders, the extraordinary and protracted low interest rates, combined with the unprecedentedly large balance sheets, have been one factor behind the legacy of higher debt that shapes the road ahead. This is deeply ironic: high debt was a key cause of the GFC but, since then, debt has continued to rise globally.

Zooming in on this general picture, and as discussed in more detail in the recent BIS Annual Economic Report, we detect clear cross-country differences. In the countries at the heart of the crisis and that experienced domestic financial booms and busts, the private sector has been de-

leveraging while, predictably, the public sector has been leveraging up. In countries less affected by the crisis, the private sector has typically been leveraging up while developments in the public sector have been more mixed, although the scenario is less reassuring in light of the flattering effects of financial booms on public finances. In fact, a number of economies have seen signs of a build-up of financial imbalances that are qualitatively similar to those observed pre-crisis in those countries that subsequently faced problems.

The international monetary and financial system has helped spread the increase in debt worldwide. Unusually easy monetary conditions in the large advanced economies that experienced the crisis or, in Japan's case, that struggled to raise inflation back to target, contributed to financial expansions elsewhere. The corresponding low interest rates boosted capital flows and put upward pressure on currencies in the rest of the world, adding to policymakers' incentive to lower policy rates to prevent unwelcome appreciation. A large part of the increase in debt was denominated in US dollars: in particular, US dollar lending to EME non-banks actually doubled post-crisis – a significant vulnerability.

Addressing the problem

How can one deal with the debt mountain? Some ways are definitely better than others. A "solution" sometimes put forward is to reduce the debt through higher inflation. The world has already been there, and it was not a pretty sight. It would make little sense to return to an inflationary era after spending so much effort to escape from it. Once the inflation genie is out of the bottle, it is very hard to get it back in. Moreover, in order to have a lasting impact on the debt outstanding, inflation would need to be combined with financial repression. The costs would mount.

Another possibility is debt restructuring. This is only a last resort, to be employed in a crisis once other, more benign alternatives have been exhausted. Restructuring can be very painful, at least when the public sector balance sheet cannot come to the rescue – an option generally highly constrained by the state of public finances and which, in the end, would simply substitute public for private debt. That said, there is scope to further explore orderly restructuring solutions to address targeted problems. It's better to be ready.

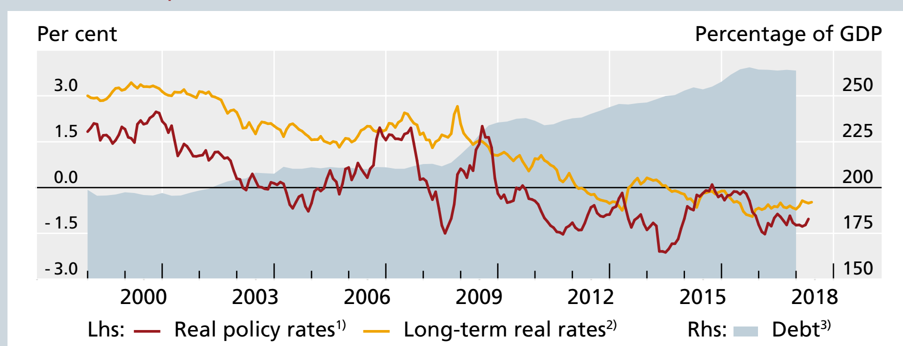
The best strategy is to adopt a policy framework that explicitly considers the risks to which rising indebtedness gives rise for sustainable economic growth and financial stability. As elaborated in the recent BIS Annual Economic Report, there is a need to develop a more holistic macro-financial stability framework. The framework includes not only macroprudential measures based on solid (microprudentially oriented) regulation and supervision of individual institutions, but also monetary, fiscal and even structural policies. The framework would result in a more balanced policy mix and, in the process, reduce the ratio of debt to GDP.

The elements of the framework are easily summarised. The regulation and supervision of individual institutions help build defences that can cushion the turn of the financial cycle, containing its costs. The active deployment of macroprudential measures during financial expansions can help restrain the development of vulnerabilities and further strengthens the financial system's resilience. A more financial stability-oriented monetary policy, through both interest rates and foreign exchange intervention, can exploit the room for manoeuvre wherever inflation remains subdued in order to better tackle the build-up of financial risks. A fiscal policy more cognisant of the flattering effect of financial booms, and of the threat posed by high debt, can provide support. And structural policies can raise sustainable, non-inflationary growth.

It would make sense to take advantage of the current favourable economic conjuncture to shift in that direction – all the more so since the room for policy manoeuvre has narrowed considerably relative to pre-crisis. Public sector debt is at a peacetime high. And central bank balance sheets are unprecedentedly large while interest rates remain exceptionally low in both nominal and real (inflation-adjusted) terms. Indeed, real rates have never been negative for so long and are negative even as countries are approaching, or may already be above, potential. The need to reload the gun for future battles is evident.

At a deeper level, shifting in the right direction requires placing a higher weight on the long term. Financial cycles, and the associated vulnerabilities, build up slowly. And the costs of high debt may emerge only after a long time. The incentive to kick the can down the road can prove irresistible. But, however distant it may appear, the future eventually becomes today. At which point, it is too late.

Into a debt trap?



1) Nominal rate less headline consumer price inflation. Simple average of Germany, Japan and the United States. 2) Simple average of index-linked 10-year government bond yields of France, Japan and the United States. 3) Total credit to non-financial sectors. Weighted average of the G7 economies plus China based on GDP and PPP exchange rates.

Sources: Bloomberg; Datastream; national data; BIS calculations