

BY MENZIE CHINN AND JEFFRY FRIEDEN

Ready for something completely different – an approach to restoring vigorous economic growth that challenges the received wisdom of our era? Read on. But first, let us set the stage.

The crisis that began as a financial bubble and morphed into a recession continues to enfeeble the economies of the United States and Europe. America's recovery is sluggish at best – both employment and output are rising far less quickly than after previous recessions. Europe is in even deeper trouble, divided between austerity and stimulus even as the Eurozone's struggling debtor nations lurch toward default. The region has slipped back into recession, which will almost certainly get worse before it gets better.

If the aftermath of the Great Recession doesn't feel like the recovery from a normal cyclical downturn, that's because it wasn't a normal cyclical downturn. We're living through the consequences of a massive global debt crisis, and debt-driven crises produce an especially malign form of recession. Recent analyses by Carmen Reinhart (Peterson Institute) and Kenneth Rogoff (Harvard) conclude that financial crises of this magnitude generally lead to lethargic growth for long periods, with the hangover typically lasting about seven years. That is because creditors

need time to rebuild their balance sheets and are thus unwilling to make risky new loans. Debtors, for their part, need to boost savings (and pare spending) to pay off their liabilities.

The politics of debt is, if anything, more daunting than the economics. A debt crisis typically degenerates into bitter political conflict over who will bear the burden of the adjustment. Some of the conflict may be among countries, with creditor nations trying to force debtors to pay off in full and debtor nations rebelling against measures that could conceivably make that possible. Other political battles take place within countries, as taxpayers, bankers, government employees, pensioners and investors jockey to avoid being saddled with the costs of working off the accumulated debts.

If we simply choose to wait for the world to find acceptable formulas for sharing sacrifice, we may be in for nearly a decade of snail's-pace growth – a truly global lost decade. To beat the 10-year sentence, banks and other financial intermediaries need to get back to the business of channeling savings to productive projects. Households and firms need to go back to a more balanced mix of saving and spending that supports growth and full employment. So far, though, policy initiatives have been a day late and a dollar/euro short,



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TRENDS

offering very little hope of a quick reversal of fortune.

Washington, Brussels and London have offered a fairly conventional – and often contradictory – mix of macro-stimulus to increase demand, austerity measures to reassure creditors and debt restructuring when all else fails. But they are loath to use a tried-and-true tool to manage crippling systemic debt: inflation.

That's no misprint: inflation. We know it reads like chalk on a blackboard sounds. But your forbearance here will pay off.

When nominal interest rates are kept below the rate of general price increases, inflation reduces the real burden of debts denominated in local currency. To put it another way, as prices rise and wages follow, debtors (households, businesses and governments) find it easier to service their debts and can more readily resume regular economic behavior.

The idea may seem radical, but it's hardly unprecedented. After World War II, the United States inflated away a portion of the debt that it had accumulated in the war years – and did so even though the economy wasn't facing an actual debt crisis. An analysis by Joshua Aizenman (University of California at Santa Cruz) and Nancy Marion (Dartmouth) points out that the federal government came out of the war with a debt equal to 109 percent of GDP, substantially more than the debt-to-GDP ratio the country faces today. But all it took to (nearly) halve the ratio between 1946 and 1955 was a mix of reasonable economic growth turbocharged by relatively mild (on average, 4 percent) inflation.

WINNERS AND LOSERS?

Inflation, to be sure, reduces the real debt burden in ways that hurt some as well as help others. Creditors, of course, receive less in real terms than they had contracted for – and

probably less than they expected when they agreed to the contract.

That may seem unfair. But the outcome is little different than what happens to creditors when they are forced to accept the restructuring of their claims through one form of bankruptcy or another. This applies to sovereign debts as well as those of households and corporations, as has been seen in the restructuring of Greek government debt.

Note, however, that the costs associated with the delay in coming to a deal may be larger than through debt reduction accomplished through inflation. It is proving extraordinarily cumbersome to renegotiate millions of mortgages and consumer loans. And in some cases, it may not even be feasible because a variety of factors – notably, the securitization of mortgages and the division of interests between loan servicers and creditors – make it impossible for the opposing parties to arrive at mutually beneficial workouts. This is especially true in the United States and parts of the Eurozone, where much of the money is owed by households.

The faster alternative to debt restructuring – and one that is arguably superior in terms of both efficiency and fairness – is to gradually (and modestly) raise the price level, effectively restructuring the real debt burden throughout the entire economy without anybody pointing fingers or tearing up contracts. This path mitigates some of the political conflict and lessens some of the drag on the economy.

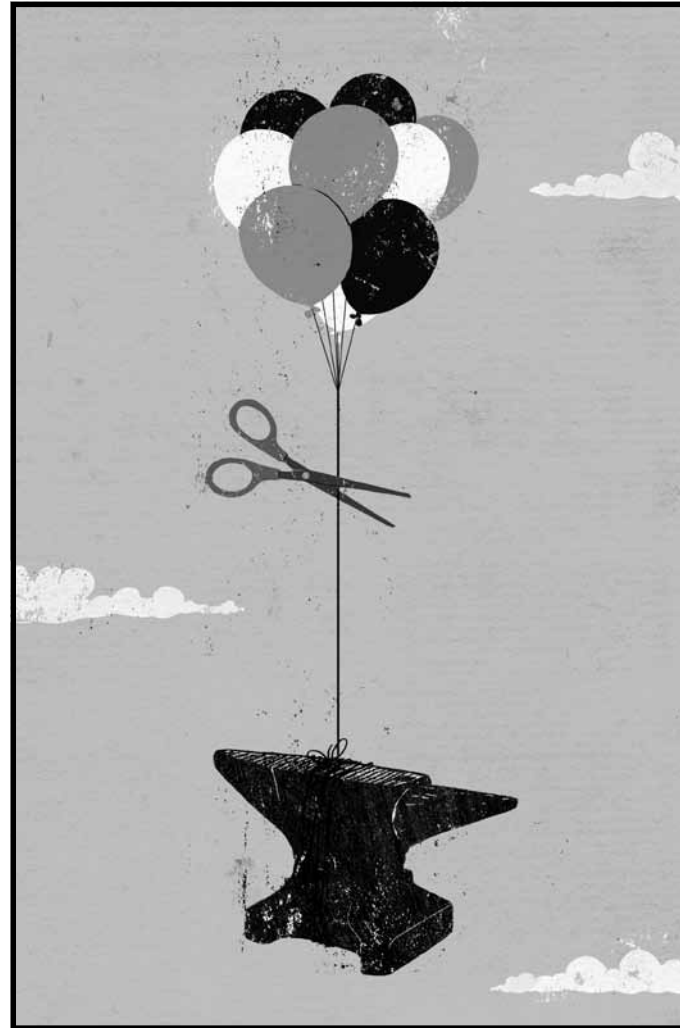
WHERE WE STAND

The world of 2012 is full of countries that have accumulated enormous debts, public and private. Some are familiar names, including Japan, Greece, Italy and Portugal. Some are less commonly seen wearing their debtor hats; Germany's burden is not that far off that of the United States' – although the composi-

tion is different, with less household debt and more corporate debt in the former. Much of the world's attention has focused on governments with oversize sovereign debts, notably Greece and Portugal. Certainly, these nations face serious difficulties in managing their economies, especially if their governments lose access to international capital markets. But the problem is broader, affecting countries whose debts are largely owed by the private sector (like Spain and Ireland). And in these latter cases, the economic and political effects of the debt overhang are every bit as severe. The United States is in this category, especially with regard to household debt.

So far, none of the major sovereign debtors has exercised the option of inflating away its liabilities. The Eurozone debtors in greatest trouble – Greece, Ireland, Italy, Portugal and Spain – do not have their own currencies or their own monetary policies, so their flexibility is limited. The problem is compounded by the fact that two-thirds to three-quarters of the foreign debt of Greece, Portugal and Spain is owed to creditors within the Eurozone, primarily in Germany and France. Even Ireland, which has strong financial ties to Britain and the United States, owes about half its debt to other Eurozone nations. That means that if the European Central Bank decided to pursue inflation as a means of real debt reduction (something it is loath to do on grounds of principle), it would be taking money out of the pockets of creditors that are also members of the Eurozone – and powerful members, too.

But as politically daunting as that might be, some redistribution from creditors to debtors would almost certainly be part of any durable settlement of the Eurozone debt crisis anyway, as it has been in the case of the Greek sovereign debt restructuring. Europe's leaders have so far been unable to arrive at



a more-encompassing settlement of intra-Eurozone debts, which means that a more aggressive monetary response to the debt burden (that is, managed inflation) may in the end prove the least unacceptable way forward.

In the United States, the Fed's response to the economic crisis has focused on stimulating the economy – appropriately, in our view. It has kept short-term interest rates extremely low through conventional means. And it has engaged in “quantitative easing,” making massive purchases of Treasury bonds and mortgage-backed securities with the goal of reducing long-term interests rates. But quantitative

TRENDS

easing has not accomplished enough, nor has the mix of short and long-term easing raised the inflation rate by more than a trivial amount. Indeed, the primary accomplishment may well have been to stave off Japanese-style deflation, which would have seriously exacerbated the debt problem.

This is hardly enough to smooth the path to speedy recovery. Yet the Fed is not planning to do much more; it is sticking with its 2 percent inflation target.

Monetary policy largely works by making it cheaper to borrow. In theory, though, one would also expect the Fed's expansionary policy to push down the international exchange value of the dollar, which would boost American exports and help pull the economy forward. (Note, too, that currency depreciation would also reduce the real value of the nation's debt to foreigners, because that debt is denominated in dollars.) However, every attempt to moderate the dollar's value has been met so far by countervailing efforts on the part of the big-surplus countries, especially China, which have been prepared to soak up the slosh of dollars in order to protect both the value of their accumulated dollar reserves and the competitiveness of their exporters. Ironically, these Fed policies aimed at depreciating the dollar have also been foiled by global investors' belief that U.S. Treasury securities are the safest way to store liquid assets in the midst of crisis.

COULD INFLATION WORK THIS TIME?

Given the world's devastating experience with stagflation in the 1970s, it is reasonable to ask whether a deliberate policy of increasing the inflation rate might not lead to the worst of both worlds. That has certainly been on the mind of Benjamin Bernanke, the Fed chairman, lately. As he said at a news conference in April:

We, the Federal Reserve, have spent 30 years building up credibility for low and stable inflation, which has proved extremely valuable in that we've been able to take strong accommodative actions in the last four or five years to support the economy without leading to an unanchoring of inflation expectations or a destabilization of inflation. To risk that asset for what I think would be quite tentative and perhaps doubtful gains on the real side would be, I think, an unwise thing to do.

It's important to remember, though, that we are not suggesting a lot of inflation – certainly nothing like the double-digit rates that followed the second oil shock in 1979 to 1981. Rather, we believe the goal should be to target moderate inflation, only enough to reduce the debt burden to more manageable levels, and adjust monetary policy accordingly. This probably means something in the 4 to 6 percent range for several years.

Perspective is needed here. The current inflation rate (not to mention the Fed's 2 percent inflation target) is very low by historical standards. Furthermore, the inflation rate as measured by the Fed's preferred metric – the personal consumption expenditure deflator – is about half a percentage point below that of the more familiar consumer price index.

The Fed could meet the goal of slightly higher inflation by adopting a flexible inflation target – one pegged to the rate of unemployment or some analogous indicator. Charles Evans, the Chicago Fed's president, has proposed something very similar: a policy that would keep the rate at which banks lend to each other overnight near zero and supplement it with quantitative measures as long as unemployment remained above 7 percent or inflation stayed below 3 percent. Making the unemployment target explicit would also serve to constrain inflationary expectations: as the unemployment rate fell, the inflation target would fall with it.

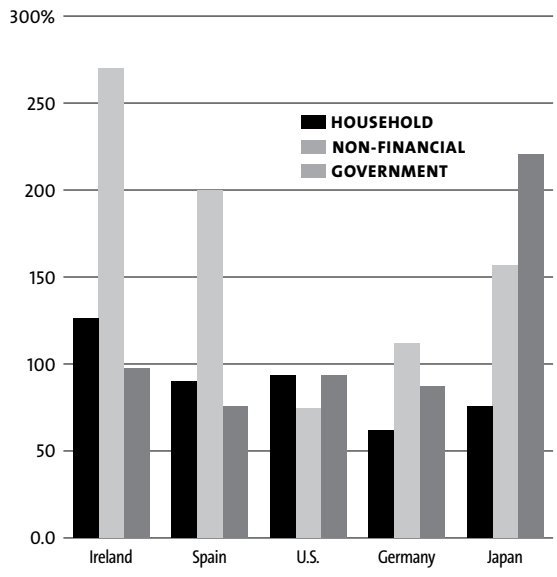
Some analysts, including the authors of a May 2011 report from the OECD, worry that higher inflation would cancel out the debt relief as debtors refinanced at higher interest rates. If the average maturity of debt (public or private) were very short, or if much of it were indexed to inflation, this worry would be well-founded.

But that isn't the case. Moreover, there is only mixed evidence that expectations of future inflation are quickly incorporated into market interest rates. For the United States over the past 30 years, the correlation between expected inflation and the rate on one-year Treasury securities is only about 0.3 – and that estimate is not statistically significant from zero correlation. Yet the payoff in terms of reducing the debt overhang would be remarkable: Aizenman and Marion estimate that – keeping in mind the ongoing need to refinance some of the debt at higher interest rates as it matures – a 6 percent inflation rate would reduce the public debt/GDP ratio from 50 percent to about 40 percent within four years.

DISORDERLY ADJUSTMENT?

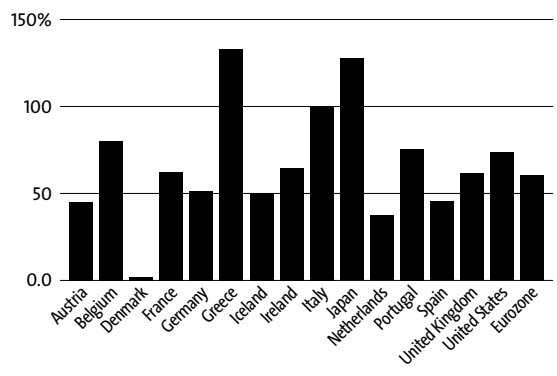
Another concern is that higher inflation would cause a flight from U.S. Treasury securities, as investors worried that they would lose value either in real terms (with inflation) or in nominal terms (with a dollar depreciation) – or both. However, investors must weigh the attractiveness of U.S. sovereign debt against the debt of other governments, many of which face even higher debt levels. And in our view, it is very unlikely that the United States would be punished severely by international investors still searching for a safe harbor in the financial storms. Even with slightly higher inflation, the dollar's movements are likely to be dominated by other factors, including U.S. fiscal and trade policies.

TOTAL DEBT TO GDP, 2010



SOURCE: Bank for International Settlements, Annual Report 2010–11

NET GOVERNMENT DEBT AS A SHARE OF GDP



SOURCE: OECD, *Economic Outlook*, November 2011

Does the same argument apply to Europe? It seems to us that the current policy of negotiating down the value of a specific government's debt (like Greece's), even as investors lose confidence in that government, is wrong in tactical terms. For one thing, this approach could trigger exactly the event it is intended to forestall: a run on a country's debt as soon

TRENDS

as renegotiation is in the works, and with great danger of contagion. The tortuous path taken to permit the relatively small Greek restructuring indicates how politically difficult the process can be.

More generally, the current path of debt restructuring in Europe is almost certainly not sustainable. The political consensus across Europe for the austerity measures imposed upon Greece and others has frayed almost to the breaking point. It is likely that Portugal, and perhaps Spain, will soon be confronted

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by similar turmoil. If matters continue as they currently stand, the prospect is for a truly disorderly adjustment, as countries face runs on their securities, lose access to capital markets and are forced into default. At that point, the European Central Bank might at last allow for managed inflation as an alternative to the collapse of the Eurozone. But by then it might not be able to control the process.

It would be simpler and less risky, then, to use more aggressive ECB monetary policy now in order to elevate the inflation rate somewhat (and to depreciate the exchange value of the euro). This would make all Eurozone government securities slightly less desirable, but it would also reduce the debt burden without requiring difficult negotiations. As

Aizenman and Marion have pointed out, it is much better to have slightly elevated inflation than to face a crisis-driven break to higher inflation as governments find themselves unable to borrow to service their debts.

EXPROPRIATION?

If and when they are taken seriously, proposals like ours will, of course, be met with howls of indignation from bond owners who regard deliberately engineered inflation as tantamount to the expropriation of their assets. To an extent, they are right. But, once again, some perspective is needed.

First, debt settlement of any sort would impose costs on both creditors and debtors. It is hard to say what ethical considerations should determine the distribution of these costs. After all, lenders lent irresponsibly and borrowers borrowed irresponsibly – so both are at fault. By the same token, there is no case to be made for any particular division of the costs in the name of economic efficiency.

Consider, too, that debt reduction depending on a formal negotiation would be extremely costly in itself, especially since it would surely lead to serious delay and uncertainty. By contrast, reducing the debt burden through inflation would be simple and across the board – and, unlike a formal restructuring, would not create a circus of interest-group politics that alienated the public and opened the door to bank runs.

Second, a reduction in the effective debt burden is in the enlightened self-interest of both debtors and creditors. This is the lesson from modern bankruptcy proceedings, and from debt restructurings past and present. For creditors, something is better than nothing; for debtors, relief is better than default;

for both, certainty is better than uncertainty. To repeat ourselves: the alternative to using inflation to cut debts to a manageable level is not their repayment in full, as some creditors dream. It is the unmanageable and potentially dangerous eruption of conflict between debtors and creditors, perhaps leading to default, acrimony and long-lasting impediments to a resumption of normal financial flows.

ALTERNATIVES

The orthodox approach to dealing with excessive debt is simply to insist that austerity measures be adopted that make it possible to repay creditors 100 cents on the dollar/euro. This is profoundly unrealistic in the current context. Indeed, we know of no general debt crisis that has been resolved without some real reduction in the sums owed. In large part, that follows from practical considerations: demands for austerity are typically counter-productive, reducing the capacity of heavily indebted households, corporations and governments to service their debts. Merely pretending that the solution is a matter of pulling up one's socks is no answer.

Reinhart and Rogoff suggest the path of "financial repression" – using the government's control of the financial system to extract wealth from the private sector to pay off public debts without the use of taxes. (One example: a requirement that banks invest a large portion of their assets in government debt, coupled with regulations that deny households the freedom to save anywhere but in low-interest bank accounts.)

It has one big virtue: it works. And it is often used in the wake of debt crises to manage what amounts to restructuring. In our view, though, it is an inferior means of debt reduction, because the economic distortions – the resulting disincentives to save, misallocation of capital and arbitrary redistribution of

income – associated with direct intervention in the financial markets are substantially greater than those created by a general increase in prices. Nor would a more active monetary policy require the development of the administrative structure of the sort needed to implement financial repression and to prevent cheating.

THE BEST OF POSSIBLE WORLDS?

Raising the expected rate of inflation would reduce the real burden of debt on households, corporations and governments, spurring both investment and consumption. And American households, which hold much of their wealth in the form of houses, would doubly benefit by a reduction of their mortgage debt relative to the value of their assets.

A slightly higher inflation rate would also have salubrious effects beyond the purely financial. Consider the adjustment of labor markets to chronic unemployment. It is widely agreed that in order to create jobs, Spain and other relatively unproductive economies on the southern periphery of the Eurozone need to reduce real wages. But it is very difficult to impose nominal wage cuts, especially in countries with strong organized labor. By contrast, a bit of inflation could erode real wages, without the perception that labor is being singled out to bear the adjustment burden.

We're not claiming that inflation is a painless way to speed deleveraging. We are claiming, though, that it is less painful than the realistic alternatives. At this juncture, the highest priority for monetary policy in the United States (and, for that matter, in Europe) ought to be getting the economy out of the long, deep recession that has cost trillions of dollars in lost output and disrupted tens of millions of lives. Unusual times call for unusual measures. **M**