Do we understand the debt burden behind COVID-19?

Henry Ergas 12:00AM July 3, 2020

Illustration: Tom Jellett

In the midst of the Weimar Republic's disastrous hyperinflation of 1923, Eduard Koppenstatter, a prominent astrologer, correlated movements in the value of the German mark with those of the planets. Having concluded that there were "law-like relations" between monetary indicators and "the course of the stars", he produced economic forecasts for the years ahead.

As things turned out, his predictions were no more inaccurate than those of the leading economists.

That should have been unsurprising. After all, Germany's circumstances were so far from normality that knowing the past provided almost no guidance about the future. As Winston Churchill put it when the

Depression struck: "The compass has been damaged, the charts are out of date."

After the tumultuous first half of this year, that applies in spades to the advanced economies. What is certain, however, is that the increases we have witnessed in public debt are unprecedented in peacetime.

In Australia alone, commonwealth and state indebtedness will rise, between this year and next, by more than $40,000 for each working-age adult.

To say that is not to condemn governments for running large deficits. It would have been politically unsustainable and morally unjustifiable to shut workplaces and destroy livelihoods without cushioning the blow. As well as causing enormous hardship, the result would have been to shatter public confidence in the political system, making recovery all the more difficult to manage.

Nor would it have been sensible to immediately finance the increased spending through higher taxes.

Even putting everything else aside, paying an additional dollar in tax is far more painful when incomes are low and uncertain than it is once economic growth has resumed and pay cheques are flowing regularly.

Rather, much as in wartime, the situation was one in which governments' ability to spread the cost of shocks between the present and the future quite properly came into its own.

However, none of that means those costs can be ignored. And the mere fact governments in the advanced economies are covering a growing share of their deficits by borrowing from central banks — that is, by printing money — hardly makes them disappear.

It is true that by purchasing government bonds, central banks can temporarily prevent rising government borrowing from pushing up nominal interest rates. And they can use their balance sheets to buy other financial assets too, bolstering their price and reducing the interest rate the owners of those assets obtain.

In turn, those low interest rates create the illusion that debts are being shifted to the future almost "for free".

Unfortunately, free lunches are not of this world — and as Thomas Sargent and Neil Wallace showed in a paper that helped earn Sargent the 2011 economics Nobel prize — the transition from "monetary dominance", in which the central bank targets the price level, to "fiscal dominance", in which it focuses on limiting the cost of public debt, is no exception to that rule.

Already now the damage is apparent. Aggressive central bank interventions have distorted the entire structure of asset prices, unmooring them from underlying risks and reducing their ability to guide efficient investment decisions.

At the same time, as returns on low-risk assets, such as government bonds, have been driven towards or below zero, investors have shifted to higher-earning but ever riskier asset classes, making financial crises increasingly likely. And, adding to the problems, the interventions have compounded the instability in exchange rates and in global capital flows, hindering international trade and undermining countries' ability to manage their economies.

There are wider consequences too. With central banks boosting asset prices, the "asset rich" are gaining while the "asset poor" are left behind, in an arbitrary income redistribution that weakens social cohesion. Meanwhile, the fraying boundary between monetary and fiscal policy has thrust central banks into taking decisions that ought to be made transparently by parliaments, compromising their standing and eroding public accountability.

How far those processes can go is hard to say. So too is whether the monetary financing of government deficits will ultimately trigger a broader inflationary spiral that, in the model Wallace and Sargent set out, “solves” the problem of accumulated debt through an inequitable and inefficient “inflation tax” on creditors and on those earning fixed incomes.

Alternatively, but hardly any better, debts and deficits may, as in Japan, simply be left to fester, in a stagnating economy that no amount of stimulus can durably revive.

Those outcomes are a choice, not a fate. Historically, they have been averted, and debt-to-GDP ratios slashed, when governments have managed to both bring deficits under control and unshackle economic growth, as the Menzies governments did in the post-war era and the Hawke and Howard governments more recently.

That, however, has never been easy — and it will be even more difficult in the years ahead.

In effect, the Menzies, Hawke and Howard governments’ efforts at fiscal repair benefited, albeit to varying degrees, from a benign world economy; in contrast, global activity may remain subdued for some time to come. And those governments won office after a period of turmoil and hardship had tempered expectations, moderating the demands on public spending. The difference with today’s electorate, which has experienced decades of rising incomes, could not be starker.

Indeed, the fact Australia has weathered today’s crisis relatively well has disguised the lockdowns’ enormous costs, bolstering public expectations of what government can deliver. As a result, rather than recognising dire fiscal realities, one interest group after the other is clamouring for greater and more prolonged handouts.

That, of course, was Weimar’s dilemma. The hyperinflation was not a policy error: it was, as Gerald Feldman brilliantly showed, the only way in which the fledgling republic could cope with interest groups sufficiently powerful to veto any policies that would share the crippling debts the war had left behind.

Unable to slow public spending, and even less able to remove the obstacles to growth, the republic gambled, disastrously, on an upswing that never came.

In the end, Feldman famously wrote, the accumulated debts proved to be a “variable rate mortgage on democracy” — and when “sectional demands robbed politics of the coherence desperately needed to manage the burden”, the interest rate on that mortgage soared past breaking point.

No doubt, all that is still far away. Nor is it conceivable that an Australian crisis would mimic Weimar’s.

But regardless of the form a crisis might take, it remains a fact that fiscal realities cannot be evaded forever. Do we have the courage to face those realities? Whatever the astrologers might say, that lies not in our stars but in ourselves.