The Risks of Fiscal Turmoil for Monetary Policy:
Some Lessons from History

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The current view of best practice central banking sees the central bank as independent of the fiscal authority pursuing a credible policy rule dedicated to price stability. The assumption behind this conception is that the fiscal authorities will also follow stable policies and aim towards balanced budgets over the business cycle. If the fiscal authorities do not maintain fiscal discipline the central bank will not use its seigniorage to close the gap.

The recent financial crisis and recession in the U.S. and the massive fiscal stimulus package that followed it has led to a fiscal deficit close to 9% and a ratio of debt to GDP close to 90%. In addition, demographics point to ever rising Social Security and Medicare entitlement expenditures and the possibility of even larger deficits and debt ratios in the not too distant future. These facts raise the specter of a disconnect between a relatively stable monetary policy and a relatively unstable fiscal policy and raises the question whether the Fed can insulate itself from the fiscal turmoil.

Recent theoretical developments suggest that even if the Fed were to follow a stable and predictable monetary rule that the U.S. may still end up with high inflation. The traditional view sees monetary policy as monetizing fiscal deficits when the government cannot raise sufficient taxes or sell bonds. Sargent and Wallace (1991) posited that unsustainably high debt ratios could lead to "unpleasant monetarist arithmetic" which forces the central bank to use its seigniorage to service and monetize the debt. The recent fiscal theory of the price level (e.g. Leeper and Walker 2011) leads to a similar bad outcome through a different mechanism. According to this framework, in normal times the central bank pursues active monetary policy—following a low inflation target—independent 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, fiscal policy will become active and monetary policy passive, referred to as a situation of fiscal dominance. 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. These theories suggest that unless a political deal is worked out to restore and maintain fiscal balance that future inflation is in the cards.

History suggests a number of examples which are very relevant for the present U.S. situation. The worst case scenario of fiscal dominance creating inflation is that of Weimar Germany in the 1920s. 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.

A comparison between the experience of Germany in the 1920s and the U.S. today may be a bit too extreme. 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 disruption in Germany after the war seems very far removed from the aftermath of a recession which, although severe by post World War II standards when compared to recessions before World War II, is relatively mild. Moreover the fact that reparations were payable in gold, i.e. that external debt was payable in 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 U.S. national debt is denominated in dollars.

The experience of France in the 1920s is much more compelling than that of Germany as an 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 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, a high ratio of debt to GDP, large fiscal deficits and a devalued exchange rate against the dollar. 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 capital stock but also a faster growth rate than in 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 with an 80% depreciation in the franc. More important, France had six years of rapidly rising prices and as in the Leeper and Walker fiscal theory of the price level 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. 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 the 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 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 seven 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 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 inflation would have increased French nominal debt to unsustainable levels. This suggests that France had to have a huge increase in the price level and a major devaluation to achieve fiscal equilibrium.

The U.S. itself had exposure to fiscal turmoil in the not too distant past which is also a cautionary tale. 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).

These historical examples suggest that if the debt ratio gets high enough, then a rise in the price level is pretty likely. However recent history also suggests that a political deal is a good possibility before such an outcome were to be reached. Two pertinent examples from the 1990s tell how such a deal can be worked out without leading to inflation.

Canada in 1995 worked out just such a deal with fundamentals not too much better than presently in the U.S. (Barnes 2011). Pierre Eliot Trudeau’s Liberal government ran increasingly higher fiscal deficits and debt ratios from the 1960s to the 1980s to finance a massive expansion of the social safety net, with the debt ratio reaching close to 50% by 1984. The succeeding Conservative government under Brian Mulroney tried unsuccessfully to restore fiscal balance but rising debt service costs pushed the debt ratio to close to 70% by the early 1990s. After a downgrade of its debt ratings by Moodys and two scathing articles in the Wall Street Journal, the succeeding Liberal government, under the guidance of Finance Minister Paul Martin, successfully restored fiscal balance. Martin’s 1995 budget drastically cut government expenditures across the board combined with minimal tax increases. Provincial governments followed suit with major spending cuts. Fiscal stringency was maintained for three years. The result was that the deficit declined from over 7 % in 1995 to a surplus by the end of the decade and the debt ratio was cut by more than half.

Similar but less dramatic fiscal consolidations were put in place in the U.S. first by the George Herbert Bush administration with the Budget Enforcement Act of 1990 and then by the Clinton administration's Omnibus Budget Reconciliation Act of 1993 . These two acts reduced fiscal deficits from close to 5% to a surplus by the end of the twentieth century with a combination of cuts in government spending and rise in tax rates. The successful fiscal outcome of the 1990s was most likely aided by the Peace Dividend after the collapse of the Soviet Union and by rapid productivity advance.

Although the political climate in Washington is more polarized than it was in the 1990s and the real economy is in worse shape, a deal still 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 easily 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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