

The Debt-Inflation Cycle and the Global Financial Crisis

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Abstract

Writing over 230 years ago, Adam Smith noted the ‘juggling trick’ whereby governments hide the extent of their public debt through ‘pretend payments.’ As the fiscal crises around the world illustrate, this juggling trick has run its course. This paper explores the relevance of Smith’s juggling trick in the context of dominant fiscal and monetary policies. It is argued that government spending intended to maintain stability, avoid deflation, and stimulate the economy leads to significant increases in the public debt. This public debt is sustainable for a period of time and can be serviced through ‘pretend payments’ such as subsequent borrowing or the printing of money. However, at some point borrowing is no longer a feasible option as the state’s creditworthiness erodes. The only recourse is the monetarization of the debt which is also unsustainable due to the threat of hyperinflation.

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1. Introduction

Writing in 1776, Adam Smith noted the following regarding public debt:

When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. ... publick bankruptcy has been disguised under the appearance of a pretend payment. ... When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor. The honour of a state is surely very poorly provided for, when in order to cover the disgrace of real bankruptcy, it has recourse to a juggling trick of this kind ... Almost all states, however, ancient as well as modern, when reduced to this necessity, have upon some occasions, played this very juggling trick (1776, pp. 929-930).

The implications of Smith's logic regarding public debt has come to fruition as evidenced by the violent situation in the streets of Athens, the situation facing the PIIGS (Portugal, Italy, Ireland, Greece, and Spain), and the pending fiscal crisis facing U.S. states such as California, Illinois, and New Jersey. In each of these instances, the current predicament did not arise over the past year or two, but rather was the result of decades of public policy decisions resulting in fiscal imbalance. While pretend payments and the juggling of finances were able to hide the underlying realities for decades, the bill has now come due.

Over 230 years after Smith wrote *The Wealth of Nations*, the Great Recession has again brought debates about the public debt, and the role of government more broadly, to the forefront. The purpose of this paper is to explore the relevance of Smith's 'juggling trick' in the context of the dominant fiscal and monetary policies. Our central argument can be stated as follows: government spending intended to maintain stability, avoid deflation, and stimulate the economy leads to significant increases in the public debt. This public debt is sustainable for a period of time and can be serviced through 'pretend payments' such as subsequent borrowing or the

printing of money. However, at some point borrowing is no longer a feasible option as the state's creditworthiness erodes. This implies that the ultimate result of Smith's juggling trick is the monetarization of the debt in order for the state to avoid bankruptcy. This too however, is an unsustainable policy due to the threat of hyperinflation which has ravaging effects as evidenced by Russia and Germany in the early 20th century.

We proceed as follows. The next section shows how the current debates over public debt mirrors the debate that took place during the 1930s between John Maynard Keynes and F.A. Hayek. We also highlight how concerns over the debt-deflation spiral emerged as part of this debate and continue to drive policy today. Section 3 discusses the mechanisms underpinning the debt-inflation cycle. We contend that the focus on deflation leads to an inflation-biased policy which neglects the cost of inflation and the logic of democratic politics which Smith highlighted in the opening quote. Section 4 lays out the dilemma we face. On the one hand we have theories indicating that active fiscal and monetary policies are necessary for recovery and growth. At the same time, we have public choice theories which indicate that increased public debt is ultimately unsustainable. Section 5 concludes with the lessons learned.

2. Back to the Future

In the 1930s, the main macroeconomic debate in economic theory and policy centered around the question of who was right, Keynes or Hayek? In the wake of the Great Depression, Keynes argued that unless action was taken to stimulate aggregate demand the economy would sink further into an abyss of unemployment and lackluster economic growth. In contrast, Hayek argued that fiscal irresponsibility threatened the recovery and long term economic health of the economy. The key to recovery and growth, according to Hayek, was private investment.

Keynes won the day in the 1930s, but in the 1970s that same debate resurfaced with a more ambivalent resolution, and since 2008 the debate has returned with a vengeance at a variety of levels. The current debate mimics the earlier debate in that there is intense academic debate about the causes of the Great Recession, as well as the best way forward. Further, as during the 1930s, the debate is also being played out in newspapers and magazines, as well as in vigorous political debates between conservative and liberal politicians on both sides of the Atlantic. Perhaps nothing illustrates how the current debate mirrors that of the 1930s than the comparison of the writings in the pages of the major newspapers (see Boettke, Smith and Snow, 2010).

On October 17, 1932, D.H. Macgregor, A.C. Pigou, J.M. Keynes, Walter Layton, Arthur Salter, and J.C. Stamp (Macgregor et al., 1932) published a letter in the *Times of London* noting that private spending was one of the primary causes for the continuation and severity of the Great Depression. They argued that immediate government action was necessary to counteract the fall in aggregate demand. Two days later, T.E. Gregory, F.A. von Hayek, Arnold Plant, and Lionel Robbins (Gregory et al., 1932) responded in the same paper arguing that private investment was necessary to recovery and growth.

Eighty years later, a similar debate took place. On February 14, 2010, a group of economists led by Timothy Besley published a letter in *The Sunday Times* arguing for a credible fiscal plan to create confidence in the robustness of the UK system. Only by reducing the structural budget deficit, the authors argued, could the confidence of private investors be maintained. Four days later, a group of economists led by Lord Skidelsky, Keynes's biographer, published a letter in *The Financial Times* arguing that the immediate concern should not be reducing the deficit, but instead ensuring the robust growth through public spending.

As the comparison of these two exchanges illustrate, the high stakes in the 1930s regarding government policy still exist decades later. However, the debate cannot be adequately understood in broad brush strokes of free market versus government intervention, or even in terms of the effectiveness of fiscal policy or monetary policy. It is much more subtle than that, even as it does turn ultimately on the question of the self-correcting capacity of the market economy. To understand the debate, one has to recognize the classic position carved out in the 1930s by Irving Fisher (1933). Fisher argued that a debt-deflationary spiral can sink an economy into a great depression unless the appropriate policies were performed to prevent the downward spiral of economic activity. Deflation, in other words, must be avoided by the monetary authorities, even at significant cost.

This preoccupation with avoiding deflation necessary leads to an inflation-biased monetary policy. The ‘chief source of the existing inflationary bias,’ Hayek wrote, ‘is the general belief that deflation...is so much more to be feared that, in order to keep on the safe side, a persistent error in the direction of inflation is preferable’ (Hayek 1960, p. 330). The practical problem in monetary policy under this set of assumptions results in a situation where because ‘we do not know how to keep price completely stable and can achieve stability only by correcting any small movement in either direction, the determination to avoid deflation at any cost must result in cumulative inflation’ (Hayek 1960, p. 330).

There are at least two major policy issues with the preoccupation with deflation. First, a positive case for declining price level can be made since deflation, if it reflects generalized productivity gains that result from technological innovation in an economy, is good, not bad (see Selgin, 1997). It is complicated, if not impossible, to sort out as a matter of public policy good deflation from bad deflation. As a result, we are back again to the situation of cumulative

inflations stressed by Hayek. Second, the self-reversing of the economic errors caused by inflation can be interpreted as a collapse in spending and a corresponding decline in economic activity as resources are reallocated, and thus those who fear deflation will call for a reflation to forestall the debt-deflation downward spiral. Hayek argues that the problem politically is that moderate inflation will be viewed pleasantly and will be revealed to be costly only in the future, whereas deflation is immediately observable and painful. Expediency in politics will reinforce the push for inflation, whereas politics by principle would demand permitting the market adjustment and the reallocation of resources however painful in the short-run (see Hayek, 1973, pp. 55-71).

The concern of deflation, and the neglect of inflation, has continued to the present day as evidenced by a recent speech by Federal Reserve Chairman Ben Bernanke (2010) where he noted that, “the FOMC will strongly resist deviations from price stability in the downward direction. Falling into deflation is not a significant risk for the United States at this time, but that is true in part because the public understands that the Federal Reserve will be vigilant and proactive in addressing significant further disinflation...”

Recognizing Fisher’s concern for the debt-deflationary spiral is crucial because while the debate between Keynes and Hayek focused largely on fiscal policy, the fear of deflation shifted focus to monetary policy. The combined result was, and continues to be, a policy characterized by a proactive Keynesian case for fiscal policy to stimulate growth, and a proactive Monetarist (and proto-monetarist) policy to avoid deflation. This, however, puts us in the very situation raised by Smith in *The Wealth of Nations*. How do we avoid the natural tendency of politicians and policymakers to engage in the juggling trick which hides the true costs of these proactive

fiscal and monetary policies through increased borrowing and the monetarization of debt which can ultimately destroy an economy?

3. The Public Debt-Inflation Cycle

Adam Smith's recognition of the juggling trick regarding public debt is especially prescient because it correctly recognized the incentives facing elected officials well before the public choice revolution of the 1960s. This focus on basic incentives was lost with the Keynesian Revolution. As Zingales (2009a) notes, 'Keynes studied the relation between macroeconomic aggregates, without any consideration for the underlying incentives that lead to the formation of these aggregates. By contrast, modern economics base all their analysis on incentives.' This is a crucial point because fiscal and monetary policy is not designed in a vacuum. Instead, we must consider the incentives at two levels. First, we must understand the incentives facing policymakers when they design policy. Second, we must consider the incentives created by those policies. Let us consider each of these incentives in turn.

The logic of Smith's 'juggling trick' insight was based on the basic incentives facing elected officials. Government can raise revenue in three ways: taxation, debt, and inflation. To maintain popularity, governmental leaders prefer not to raise explicit taxes, so the preferred method of revenue generation is to borrow and then pay debts back with debased currency (an implicit tax). The democratic bias is to concentrate the benefits of public policy on well-organized and well-informed voters in the short run, and disperse the costs of public policy on the ill-organized and uninformed masses in the long run. The least informed and organized interest group at any point of time is future generations. Hence, the natural proclivity for the ruling regime is to run deficits that result in accumulated public debt, which is paid off with

debasement. Throughout history this governmental habit of deficit, debt, and debasement is what has brought down regimes and with that sometimes civilizations (see Groseclose 1961, pp. 57-76; Rothbard 1963, pp. 63-4).

It is this logic which has historically underpinned calls for an *independent* central bank, and various constraints on the policy discretion of both the treasury and the central bank. Ideally, rules must be designed to prevent policy cooperation/collusion between the fiscal and monetary policy makers precisely because we know the history of the political temptations to be seduced by the opportunity to engage in the juggling trick that Adam Smith so long ago identified.

However, the problem goes beyond the incentives facing policymakers. The process of engaging in Smith's juggling trick also creates perverse incentives in the private arena as proactive fiscal and monetary policies have led to increased efforts on the part of private actors to influence these policies for their personal gain. This raises the return to lobbying and rent seeking activities relative to productive entrepreneurial activities, which are necessary not only for immediate recovery, but for long term growth.

This interplay between the incentives facing policymakers and private business people has resulted in a 'vicious circle' of favoritism and a lack of trust in financial and political institutions by citizens (see Zingales, 2009b). Politicians are intertwined with private markets as the logic of special interests discussed above (see Smith, Wagner, and Yandle, 2011). At the same time, politicians seek to signal to citizens that they are independent of private interests. They do so by adopting strong policies against those private interests in the wake of crisis—increased regulation, threatened and actual taxes and fines, etc. This attempt to send a strong signal, however, has the unintended effect of creating an uncertain environment for subsequent

investment which further exacerbates the fundamental problem of encouraging private investment for recovery and growth.

4. Misdiagnosing the Sickness and Cure

We are faced with a dilemma. On the one hand, the dominant theories of economic crises indicate that government must play a pro-active role in getting the economy out of the depressed state of affairs. Active fiscal policy must be used to stimulate aggregate demand while active monetary policy must be used to avoid a deflationary spiral. However, we also have public choice theories dating back to Adam Smith, which indicate that these very government actions are unsustainable and economically destructive.

The trends seem to support the Smith/public choice line of reasoning. In *Capitalism and Freedom* (1962, p. 75) Milton Friedman pointed out that the primary justification of the expansion of public expenditure since WWII has been the ‘supposed necessity for government spending to eliminate unemployment.’ An idea, Friedman goes on to argue that has been thoroughly discredited by theory and practice. But, as he points out, ‘The idea may be accepted by none, but the government programs undertaken in its name, like some of those intended to prime the pump, are still with us and indeed account for ever-growing government expenditures’ (1962, p. 76). Close to 20 years later, Friedman noted that little had changed from when he first made those observations. ‘The repeated failure of well-intentioned programs is not an accident. It is not simply the result of mistakes of execution. The failure is deeply rooted in the use of bad means to achieve good objectives.’ But in spite of the overwhelming record of failure, these programs continue to expand. ‘Failures are attributed to the miserliness of Congress in

appropriating funds, and so are met with a cry for still bigger programs' (Friedman and Friedman, 1980, pp. 87-88).

Further, in the 25 plus years since those words were written little has changed in the day to day operation of politics, though Friedman was successful in transforming the rhetoric in the direction of market-economics language. At best, the growth of government was slowed, but it is important to stress that neither the Reagan nor Thatcher administrations reversed the trend line, and in the subsequent years even that slowing of the growth of government was reversed, especially after the September 11, 2001 terrorist attacks and the ensuing military conflicts and enhanced domestic security measures.

It is important to stress this because one of the great mythologies is that the Great Recession is evidence of the failure of unregulated capitalism. A similar mythology arose concerning the Great Depression. As Friedman and Friedman summed it up:

The depression convinced the public that capitalism was defective; the war, that centralized government was efficient. Both conclusions were false. The depression was produced by a failure of government, not of private enterprise. As to the war, it is one thing for government to exercise great control temporarily for a single overriding purpose shared by almost all citizens and for which almost all citizens are willing to make heavy sacrifices; it is a very different thing for government to control the economy permanently to promote a vaguely defined "public interest" shaped by the enormously varied and diverse objectives of its citizens (1980, pp. 85-86).

Failing to distinguish between unregulated capitalism and state-led capitalism, or mercantilism, has two negative consequences. The first is that it runs the risk of misdiagnosing the problem. If failures are attributed to capitalism when they are in fact the result of distortions caused by fiscal and monetary policies, this will lead to an incorrect diagnosis of the actual problem. The second, and related consequences, is that it runs the risk of misdiagnosing the solution. If, in fact, the

cause of downturns is distortions caused by past fiscal and monetary solutions, then it is incorrect to assume that these same policies are the solution to the very problem they caused.

There is reason to believe that both types of misdiagnoses are at work in the current crisis. Zingales (2009a) notes that Keynesian policies have not only failed to avoid the current crisis and instead were a contributing factor to its onset. He writes that ‘The Keynesian desire to manage aggregate demand, ignoring the long-run costs, pushed Alan Greenspan and Ben Bernanke to keep interest rates extremely low in 2002, fuelling excessive consumption by the household sector and excessive risk-taking by the financial sector’ (Zingales 2009a). Similarly, Taylor (2009) has documented how easy monetary policy combined with government programs which unintentionally shifted the incentives for risk taking caused and prolonged the current crisis. Finally, Rajan (2010) highlights how the role of loose monetary policy and the political push for easy housing credit contributed to the current crisis.

Prior to the onset of the crisis, economists too quickly identified the lack of macroeconomic volatility with the perfection of central banking, rather than seeing policies in terms of Smith’s juggling trick whereby fiscal and monetary policies to paper over (literally) the efforts by market forces to correct for the misleading signals of the previous period of the manipulation of money and credit in the economy. The Fed ‘getting off track,’ to borrow Taylor’s (2009) apt phrase, was due to efforts to keep the previous misguided set of economic activities afloat rather than permitting the necessary adjustment to economic reality by market participants.

To the extent that Zingales, Taylor, and Rajan are correct that past fiscal and monetary policies were factor in causing the current situation, what confidence do we have that those same policies can now solve the existing predicament they helped to create? Further, to the extent that

these policies are successful, they will only be so in the short run as they are just a continuation of the juggling trick. As the debt crises around the world illustrate, while payment can be delayed, eventually the bill comes due.

5. Lessons Learned

What have we learned from the Great Recession? We would like to highlight three lessons which we hope will be the subject of subsequent debate and discussion.

First, the debt-*inflation* theory of economic crises must be considered as a viable alternative to replace the debt-deflation theory of economic crises. Under the debt-deflation theory policymakers interpret every downturn in economic activity as a potential deflation, and therefore counteract it with easy monetary policy. When this happens market corrections will be cut short, and the previous boom is recreated through the manipulation of money and credit.

Ludwig von Mises (1949) and F.A. Hayek (1979) were early expositors of an expectation based macroeconomics arguing that efforts to off-set economic downturns through monetary policy enter a dangerous game of expectations and anticipated inflation. As Hayek argued: ‘We now have a tiger by the tail: How long can this inflation continue? If the tiger (of inflation) is freed, he will eat us up; yet if he runs faster and faster while we desperately hold on, we are *still* finished!’(1979, p. 110) It is this theory of the ‘crack-up boom’ (see Mises 1949, pp. 426-428) that very well *may* be what we have seen manifesting itself in reality with the onset of the Great Recession in 2008. If this is accurate then the policy steps taken to date have merely reinforced, rather than ameliorated, the problem as a market correction to previous malinvestments has been turned into a global crisis by the very steps taken to prevent the market correction from occurring.

Second, to curtail the tendency of using the tools of monetary and fiscal policy to concentrate benefits and disperse costs, policy institutions must effectively tie the rulers' hands to eliminate the possibility of engaging in the juggling trick that Smith warned against. The importance of establishing credible and binding constraints on monetary authorities and government spending is by no means a new idea. However, modern history has demonstrated the elusiveness of the quest to establish binding and credible constraints on the monetary and fiscal authorities.

This has important implications because the relevant question is not *if* constraints should be established, but instead *can* binding constraints be established within the existing institutional framework. If that institutional framework is vulnerable to the inevitable errors committed by policy makers—either innocent or malevolent—then the problem is not *in* the framework, it *is* the framework. Milton Friedman (1962, pp. 50-51) recognized this possibility when he wrote that:

Any system which gives so much power and so much discretion to a few men that mistakes – excusable or not – can have such far reaching effects is a bad system. It is a bad system to believers in freedom just because it gives a few men such power without any effective check by the body politic – that is the key political argument against an ‘independent’ central bank. But it is a bad system even to those who set security higher than freedom. Mistakes, excusable or not, cannot be avoided in a system which disperses responsibility yet gives a few men great power, and which thereby makes important policy actions highly dependent on accidents of personality. This is the key technical argument against an “independent” bank. To paraphrase Clemenceau, money is much too serious a matter to be left to the Central Bankers.

Similarly, Buchanan and Wagner are pessimistic of the ability to restrain the state from engaging in juggling tricks leading them to conclude that, ‘...*politically*, Keynesianism may represent a substantial disease, one that can, over the long run, prove fatal for a functioning democracy’ (Buchanan and Wager, 1977, p. 56).

This leads to our third and final lesson. After centuries of only fleeting success at curtailing the deficit, debt, and debasement cycle of public policy, we may have to seriously consider the possibility that the only way to successfully constrain the state is to eliminate from its purview the task of monetary policy. Rather than a centralized and government monopoly control of the money supply, perhaps more decentralized and competitive institutional arrangement might have to be relied upon. Of course, what is required is the attention of economists to examine such institutional arrangements in depth and with all their critical attention. What cannot continue is the standard practice of looking at central banking theory and practice as if it was to be done by fully informed agents who act only in the public interest. Instead, a robust theory of the institutions of the monetary framework must be developed.

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