



Fiscal Policy and Expected Inflation

Christopher J. Neely, *Assistant Vice President and Economist*

Unless something is done, the United States faces the prospect of unprecedented deficits and exploding debt-to-GDP (gross domestic product) ratios. Budget analysts forecast the publicly held U.S. debt-to-GDP ratio will rise from 60 percent at 2010 fiscal year-end to 185 percent by 2035. Although a few developed countries (e.g., Japan and Italy) have managed to avoid default with very high debt-to-GDP ratios, rising prices of credit default swaps (CDSs) on U.S. debt indicate that financial markets now consider a U.S. default possible, if still highly unlikely. CDSs function much like insurance for bonds: The buyer of a CDS pays an annual premium in exchange for insurance against the possibility of default by the bond issuer. Just as the likelihood of an auto accident affects the price of auto insurance, CDS premia reflect changes in market expectations about the likelihood that a bond issuer—such as a corporation or government—will default. CDS rates on U.S. debt have risen from less than 5 basis points per annum in 2007 to more than 40 basis points recently. The possibility of a technical default—in which wrangling over the debt ceiling delays bond payments by a few days—might produce some of the increase in CDS rates, but fears of a substantive default are also likely to have risen. Investors are much more wary of an explicit U.S. default.

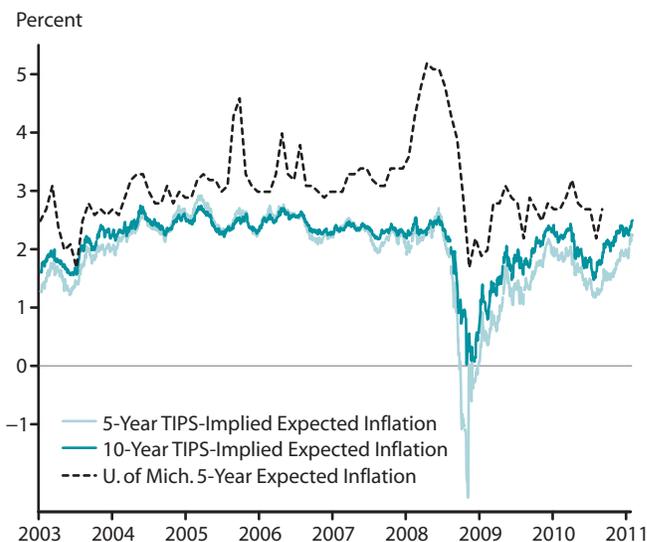
A country in an untenable fiscal situation can evade its debt obligations in at least two ways. The first is to default by canceling or restructuring debt. The second (and indirect) way to default is by raising the domestic price level with surprise inflation—reducing the real value of nominal bonds denominated in the domestic currency. Although Federal Reserve Chairman Ben Bernanke has been steadfast in stating that the Fed will not allow inflation to rise above 2 percent—which the Fed has traditionally equated with price stability—some analysts predict the Fed will use inflation to greatly reduce the real value of U.S. debt.¹

Despite U.S. fiscal problems, the Fed appears to still retain excellent inflation credibility with financial markets. The chart shows that expected inflation from both Treasury Inflation-Protected Security (TIPS) spreads measures and professional economists' forecasts seems to

be well anchored near 2 percent. Markets and forecasters appear to discount the possibility of using inflation to reduce the value of U.S. debt.

Despite U.S. fiscal problems, the Fed appears to still retain excellent inflation credibility with financial markets... Although confidence in the Fed might explain the quiescence of inflation expectations, the structure of U.S. government debt may be more important... [I]nflating away the U.S. debt simply would not work because a high proportion of the debt is in short-term or inflation-protected securities.

Expected Inflation



NOTE: The chart shows three measures of expected consumer price index inflation. The TIPS measures show expected inflation that is implied by real and nominal Treasury bond yields. The Thomson Reuters/University of Michigan survey measures consumer inflation expectations.

Although confidence in the Fed might explain the quiescence of inflation expectations, the structure of U.S. government debt may be more important. Each year, almost 40 percent of privately held U.S. government debt matures and must be refinanced. A surprise burst of inflation would reduce the real value of this debt but also greatly increase the cost of rolling it over and perhaps make it impossible to roll over. Furthermore, 7 percent of the U.S. debt consists of TIPS whose payments would rise commensurately with increases in the consumer price index.²

In other words, inflating away the U.S. debt simply would not work because a high proportion of the debt is in short-term or inflation-protected securities. Some combination of reduced spending and/or higher taxes would reduce the default risk and create a sustainable fiscal path. ■

¹ Chairman Bernanke has said recently that “We’ve been very, very clear that we will not allow inflation to rise above two percent or less” (www.clipsandcomment.com/2010/12/06/transcript-ben-bernanke-on-60-minutes-december-5-2010/) and “Well, first, let me say that we’re not going to be monetizing the debt” (see p. 35 of http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_house_hearings&docid=f:56766.pdf).

² The short-maturity debt also includes some near-to-maturity TIPS.