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Austerity is not the only answer to a debt problem

By Kenneth Rogoff and Carmen Reinhart

Policy makers must use all the tools available, write Kenneth Rogoff and Carmen Reinhart



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The recent debate about the global economy has taken a distressingly simplistic turn. Some now argue that just because one cannot definitely prove very high debt is bad for growth (though the weight of the results still say it is), then high debt is not a problem. Looking beyond the recent public debate about the literature on debt – we have already discussed our results on debt and growth in that context – the debate needs to be reconnected to the facts.

Let us start with one: the ratios of debt to gross domestic product are at historically high levels in many countries, many rising above previous wartime peaks. This is before adding in concerns over contingent liabilities on private sector balance sheets and underfunded old-age security and pension programmes. In the case of Germany, there is also the likely need to further cushion the debt loads of eurozone partners. Some say not to worry, pointing to bursts of growth after the world wars. But today's debts will not be dealt with by boosts to supply from postwar demobilisation and to demand from the lifting of wartime controls.

To be clear, no one should be arguing to stabilise debt, much less bring it down, until growth is more solidly entrenched – if there remains a choice, that is. Faced with, at best, haphazard access to international capital markets and high borrowing costs, periphery countries in Europe face more limited alternatives.

Nevertheless, given current debt levels, enhanced stimulus should only be taken selectively and with due caution. A higher borrowing trajectory is warranted, given weak demand and low interest rates, where governments can identify high-return infrastructure projects. Borrowing to finance productive infrastructure raises long-run potential growth, ultimately pulling debt ratios lower. We have argued this consistently since the outset of the crisis.

Ultra-Keynesians would go further and abandon any pretence of concern about longer-term debt reduction. This position has been in the rhetorical ascendancy in recent months, with new signs of weaker growth. It throws caution to the wind on debt and, to quote *Star Trek*, pushes governments to “go where no man has gone before”. The basic rationale is that low interest rates make borrowing a free lunch.

Unfortunately, ultra-Keynesians are too dismissive of the risk of a rise in real interest rates. No one fully understands why rates have fallen so far so fast, and therefore no one can be sure for how long their current low level will be sustained. John Maynard Keynes himself wrote *How to Pay for the War* in 1940 precisely because he was not blasé about large deficits – even in support of a cause as noble as a war of survival. Debt is a slow-moving variable that cannot – and in general should not – be brought down too quickly. But interest rates can change rapidly.

True, research has identified factors that might combine to explain the sharp decline in rates. Greater concern over potentially devastating future events such as fresh financial meltdowns may be depressing rates. Similarly, the negative correlation between returns on stocks and long-term bonds, while admittedly quite unstable, also makes bonds a better hedge. Emerging Asia's central banks have been great customers for advanced economy debt, and now perhaps the Japanese will be once more. But can these same factors be relied on to keep yields low indefinitely?

Economists simply have little idea how long it will be until rates begin to rise. If one accepts that maybe, just maybe, a significant rise in interest rates in the next decade might be a possibility, then plans for an unlimited open-ended surge in debt should give one pause.

What, then, can be done? We must remember that the choice is not simply between tight-fisted austerity and freewheeling spending. Governments have used a wide range of options over the ages. It is time to return to the toolkit.

First and foremost, governments must be prepared to write down debts rather than continuing to absorb them. This principle applies to the senior debt of insolvent financial institutions, to peripheral eurozone debt and to mortgage debt in the US. For Europe, in particular, any reasonable endgame will require a large transfer from Germany to the periphery. The sooner this implicit transfer becomes explicit, the sooner Europe will be able to find its way towards a stable growth path.

There are other tools. So-called “financial repression”, a non-transparent form of tax (primarily on savers), may be coming to an institution near you. In its simplest form, governments cram debt into domestic pension funds, insurance companies and banks. Europe is there

already – and it has been there before, several times. *How to Pay for the War* was, in part, about creating “captive audiences” for government debt. Read the real Keynes, not rote Keynes, to understand our future.

One of us attracted considerable fire for suggesting moderately elevated inflation (say, 4-6 per cent for a few years) at the outset of the crisis. However, a once-in-75-year crisis is precisely the time when central banks should expend some credibility to take the edge off public and private debts, and to accelerate the process bringing down the real price of housing and real estate.

Structural reform always has to be part of the mix. In the US, for example, the bipartisan blueprint of the Simpson-Bowles commission had some very promising ideas for simplifying the tax codes.

There is a scholarly debate about the risks of high debt. We remain confident in the prevailing view in this field that high debt is associated with lower growth. Certainly, let's not fall into the trap of concluding that today's high debts are a non-issue. Keynes was not dismissive of debt. Why should we be?

The writers are professors at Harvard University. They have written further on carmenreinhardt.com

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