WSJ 6/15/20

THE OUTLOOK | By Paul Hannon

# Debt Battle Awaits Post-Virus World

Leaders around the world have compared their efforts to bring the novel coronavirus under control to fighting a war. The similarities may not end when the battle to tame the virus has been won, and the debts accumulated by governments have to be repaid.

In the U.S. and elsewhere, government debt is set to soar this year, reflecting lower tax revenue and the cost of financial aid to businesses and households during lockdowns. The International Monetary Fund forecasts that U.S. government debt will reach 131% of annual economic output this year, up from 109% in 2019.

That is a higher debt burden than after World War II. Other countries are facing similarly high debt levels, including the U.K., France, Italy and Spain.

Some people thinking about how to pay down the debt are looking at an approach used after World War II: financial repression, or policies that ensure that interest rates remain low. They include central-bank purchases of government bonds and regulations prodding investors to hold such securities, said Keith Wade, chief economist at Schroders. Such measures would help hold down bond yields, lowering interest costs over time.

"It is increasingly likely that governments will rely on financial repression to erode their debt-to-income ratios," he said.

In the years after World War II, the Federal Reserve and Treasury Department ran a joint operation to support prices of government bonds—which kept interest rates down—while other measures in the U.S. and elsewhere placed limits on interest rates paid by banks, making alternatives to government bonds less attractive to investors.

Similar measures were adopted by the U.K. and other governments, and they worked.

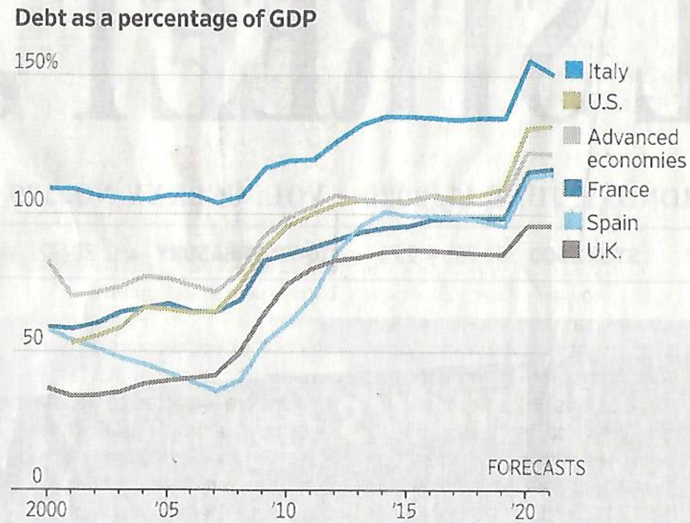
According to a 2015 paper by economists Carmen Reinhart and M. Belen Sbrancia, financial repression lowered the average interest bill of 12 governments by between 1% of gross domestic product and 5% from 1945 to 1980.

The system "played an instrumental role in reducing or liquidating the massive stocks of debt accumulated during World War II," they wrote.

Some economists see financial repression as a strong option, in part because the main alternatives don't appear promising.

In theory, an acceleration in economic growth would make it possible to repay the debt quickly. But such a pickup appears unlikely for economies with slowly growing populations and productivity.

Government debts are set to jump as tax revenues slide and the costs of supporting businesses and households mount.




Source: International Monetary Fund

Another approach would be to encourage higher inflation, which allows the nominal debts incurred today to be paid down with cheaper money in the future. But developed-economy central banks have tried and failed for most of the past decade to lift inflation to their targets around 2% for a variety of reasons unlikely to go away, such as aging populations, slow economic growth, globalization, advancing technology and low interest rates.

And if central banks succeeded in fueling much higher inflation, they could risk letting it get out of control—which would harm the economy and prove extremely unpopular, as in the 1970s.

The other main option for whittling down the debt is a combination of spending cuts and tax increases, or austerity, which proved politically divisive after the 2009 global recession.

"If the austerity debate continues to be as poisonous as it is now, the way to pay down debt may be through financial repression," said Ricardo Reis, an economist at the London School of Economics.

Financial repression isn't without its costs and risks. While the costs of austerity would largely fall on lower-income households, the suppression of interest rates would hit savers.

Financial repression also requires a level of coordination between a nation's monetary and fiscal authorities that most central bankers prefer to avoid for fear of losing their independence from political pressures.

As Mr. Reis has chronicled, tensions between the Fed and the Treasury over the former's debt mandate often appeared "worthy of a political drama TV series," and culminated in the 1951 Treasury-Fed accord, under which supporting the national debt was no longer an objective for monetary policy.

Similar debates in coming years might not have the same outcome. They also may be postponed for a while. In the heat of the battle, nobody is spending too much time worrying about how those pandemic-related debts will be managed.

"You're talking to a very fiscally conservative person," said Ms. Reinhart, the World Bank's newly appointed chief economist, in response to a question on the wisdom of borrowing so much in response to the pandemic. "But this is a war. In a war, you worry about winning the war, and then you worry about paying for it."