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**ABSTRACT**

As a share of GDP, the U.S. Federal debt held by the public exceeds 50 percent in FY2009, the highest debt ratio since 1955. Projections indicate the debt ratio may be in the 70-100 percent range within ten years. In many respects, the temptation to inflate away some of this debt burden is similar to that at the end of World War II. In 1946, the debt ratio was 108.6 percent. Inflation reduced this ratio about 40 percent within a decade. Yet there are some important differences –shorter debt maturities today reduce the temptation to inflate, while the larger share held by foreigners increases it. This paper lays out an analytical framework for determining the impact of a large nominal debt overhang on the temptation to inflate. It suggests that when economic growth is stalled, the U.S. debt overhang may trigger an increase in inflation of about 5 percent for several years. This additional inflation would significantly reduce the debt ratio, even with some shortening of debt maturities.

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## I. Introduction

Since the start of 2007, the financial crisis has triggered \$1.62 trillion of write-downs and credit losses at U.S. financial institutions, sending the American economy into its deepest recession since the Great Depression and the global economy into its first recession since World War II. The Federal Reserve has responded aggressively. In an effort to hold down borrowing costs and boost lending, it has kept the target rate for overnight loans between banks at zero to 0.25 percent since December, 2008, and it has pursued unconventional monetary easing.<sup>1</sup> Fiscal policy has become expansionary as well. The \$700 billion Troubled Asset Relief Program and the \$787 billion Economic Recovery and Reinvestment Act have been signed into law. In all, Federal spending has increased 18 percent in FY2009, to nearly 25 percent of GDP, the highest level in over fifty years. Revenues have fallen almost 17 percent below receipts in 2008, to about 15 percent of GDP, the lowest level in over fifty years.<sup>2</sup>

The United States is now facing large Federal deficits and growing public debt. The Federal deficit, estimated at \$1.4 trillion in FY2009, or 9.9% of GDP, is the highest deficit-to-GDP ratio since 1945.<sup>3</sup> The Federal debt held by the public is expected to be over \$6 trillion, or 53.8% of GDP, at the end of FY2009, the highest debt-to-GDP ratio since 1955.<sup>4</sup> The total outstanding Federal debt for FY2009 is predicted to exceed \$11.8 trillion, about 90% of GDP.<sup>5</sup>

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<sup>1</sup> Federal Reserve Press Releases, various dates.

<sup>2</sup> Daily Treasury Statement (September, 2009) and Monthly Treasury Statement (August, 2009).

<sup>3</sup> U.S. Treasury.

<sup>4</sup> Congressional Budget Office (2009) estimates. The Office of Management and Budget (2009) estimates public debt to be 55.7 percent of GDP in 2009, while the IMF(2009) projects it to be 58.2 percent.

<sup>5</sup> The Budget of the United States Government, FY2009, p. 230, states: The Federal Government issues debt securities for two principal purposes. First, it borrows from the public to finance the Federal deficit. Second, it issues debt to Government accounts, primarily trust funds that accumulate surpluses. By law, trust fund surpluses must generally be invested in Federal securities. The gross Federal debt is defined as the sum of debt held by the

If economic recovery is slow to take hold, large deficits and growing debt are likely to extend into future years. Not surprisingly, concerns about government deficits and public debt now dominate the policy debate.

Many observers worry that the debt/GDP ratios projected over the next ten years are unsustainable.<sup>6</sup> Given that concern, and assuming that deficits can be reined in, how might the debt/GDP ratio be reduced? There are four basic mechanisms. First, GDP can grow rapidly enough to reduce the ratio. This scenario requires a robust economic recovery from the financial crisis. Second, inflation can rise, eroding the real value of the debt held by creditors and the effective debt ratio. With foreign creditors holding a significant share of the dollar-denominated U.S. Federal debt, they will share the burden of any higher U.S. inflation along with domestic creditors.<sup>7</sup> Third, the government can use tax revenue to redeem some of the debt. Fourth, the government can default on some of its debt obligations. Over its history, the United States has relied on each of these mechanisms to reduce its debt/GDP ratio.<sup>8</sup> In this paper, we examine the role of inflation in reducing the Federal government's debt burden.

We start in Section II by laying out some stylized facts. We examine Federal debt held by the public since World War II and show how publicly-held debt as a percentage of GDP has evolved. Since the impact of higher inflation on the debt/GDP ratio will depend on the maturity of the debt, we provide time-series evidence on average maturity length. We also observe that

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public and the debt held by Government accounts. Borrowing from the public is normally a good approximation of the Federal demand on credit markets. Borrowing must be financed out of the saving of households and businesses, the State and local sector, or the rest of the world. Borrowing from the public thus affects the size and composition of assets held by the private sector and the amount of saving imported from abroad. It also increases the amount of future resources required to pay interest to the public on Federal debt. Borrowing from the public and the growth of the publicly-held Federal debt are therefore important policy concerns.

<sup>6</sup> For example, see Alan Auerbach and William Gale (2009).

<sup>7</sup> The real depreciation of the dollar also erodes the value of U.S. public debt held by foreigners. See Rogoff (2009).

<sup>8</sup> For a brief discussion of debt management after the American Revolution and Civil War, see the Appendix.

very little of the debt is indexed to inflation, despite the introduction of Treasury inflation-protected securities (TIPS) in 1997, and all debt is denominated in dollars.

The distributional impact of inflation depends on the allocation of debt between domestic and foreign creditors, so we next show how the share held by foreigners has grown over time. We end this section by computing the impact of various inflation scenarios on the debt/GDP ratio, and we calculate how the inflation burden would be shared between domestic and foreign creditors.

In Section III, we develop a model that shows the impact of a nominal debt overhang on the temptation to inflate. The model illustrates that the optimal inflation rate is also positively related to the share of the debt held by foreign creditors, the cost of tax collection, and the share of non-indexed debt. Model simulations suggest that when economic growth is stalled, the U.S. debt overhang may trigger an increase in inflation of about 5 percent for several years. This additional inflation would significantly reduce the debt ratio, even with some shortening of debt maturities.

In Section IV, we conclude by comparing the current period with a past period in U.S. history when the debt overhang was high. We argue that today's temptation to inflate away some of the debt burden is similar in some respects to that in 1945, when inflation successfully eroded a substantial part of the debt burden. Yet there are important differences—shorter debt maturities today reduce the temptation to inflate, while the larger share held by foreign creditors increases it.

## II. The Stylized Facts

Figure 1 depicts trends in gross Federal debt and Federal debt held by the public from 1939 to the present.<sup>9</sup> In 1946, just after the end of World War II, gross Federal debt reached 121.7 percent of GDP and the share held by the public was 108.6 percent. Over the next 30 years, debt as a percentage of GDP decreased almost every year, due primarily to an expanding economy as well as inflation. The end result was noteworthy. By 1975, gross Federal debt had declined to 34.7 percent of GDP, and the share of debt held by the public had fallen to 25.3 percent.

The immediate post-World War II period is especially revealing. Figure 2 shows that between 1946 and 1955 the debt/GDP ratio was cut almost in half. The average maturity of the debt in 1946 was 9 years and the average inflation rate over this period, even with a spike to 14.4 percent in 1947, was 4.2 percent. Hence, inflation reduced the 1946 debt/GDP ratio by almost 40 percent within a decade.<sup>10</sup>

Returning to Figure 1, we see that debt/GDP ratios stopped declining by the mid-1970s, when the economy was hit by oil shocks and fiscal deficits increased. In the early 1980s, the debt/GDP ratio grew sharply as the economy faced recession and a re-emerging fiscal deficit. Legislated tax cuts and increased government defense expenditures fueled even greater fiscal deficits and higher debt.

By the mid-1990s, however, the debt/GDP ratio again began falling. Gross debt fell steadily from 66.2 percent of GDP in 1993 to 57.4 percent in 2001, while the debt held by the public fell by about a third, from 49.4 percent of GDP in 1993 to 33.0 percent in 2001. Over the

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<sup>9</sup> Recall that the difference between gross Federal debt and debt held by the public is the debt held in government accounts, primarily trust funds. Debt held by the Federal Reserve is included in debt held by the public.

<sup>10</sup> See the end of this section for the computation method.

period 1993-2001, average inflation was about 2.5 percent and the average maturity of the publicly-held debt was about 5.75 years, so inflation contributed very little to the erosion of the debt/GDP ratio (less than 15 percent). Most of the decline in the debt/GDP ratio was due to robust GDP growth.

The downward trend in the debt/GDP ratio ended in 2001. With a recession, a slow recovery that reduced tax receipts, legislated tax cuts and increased spending due to the War on Terror, a government budget surplus turned to deficits and debt began to rise in 2002, both in nominal terms and as a percentage of GDP. However, a growing economy led to a small decline in the debt ratio between 2005 and 2007.

With the onset of the financial crisis, government deficits and the debt/GDP ratio increased dramatically. In FY 2009, the debt-to-GDP ratio reached a level not seen since 1955. Figure 3 shows 10-year projections made by the International Monetary Fund, the Congressional Budget Office, and the Office of Management and Budget. These projections indicate debt held by the public could be 70-100 percent of GDP in ten years.

A government that has lots of nominal debt denominated in its own currency has an incentive to try to inflate it away so as to decrease the debt burden. It will resist the urge to inflate if the rewards are small and the cost of a lost reputation is high. The average maturity of the debt and the share that is indexed to inflation affect the ability of the government to inflate away its value. In the extreme cases of zero maturity or fully-indexed debt, the government is unable to reduce its debt burden through inflation.

Figure 4 illustrates the average maturity length for U.S. marketable interest-bearing public debt held by private investors, along with the debt held by the public as a share of GDP.<sup>11</sup>

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<sup>11</sup>Prior to 1971, maturity length applies to interest-bearing public debt. Since 1971, maturity length applies to interest-bearing public debt held by private investors. Debt held by private investors was 82% of debt held by the

As noted by a number of authors, the United States exhibits a positive relation between maturities and debt/GDP ratios in the post-World War II period.<sup>12</sup> Most developed countries show little correlation between maturities and debt/GDP ratios. The United States appears to be an exception.<sup>13</sup> Maturity length on U.S. public debt in the post-World War II era went from a high of 113 months (9.4 years) in 1947 to a low of 31 months (2.6 years) in 1976. It then climbed again, with some ups and downs, reaching a peak of 74 months (6.2 years) in 2000 before falling back to 49 months (4.1 years) in 2008. In June, 2009, the average maturity was 47 months (3.9 years).

In the past two years, the portion of Treasury debt at the shortest maturity has risen markedly. Figure 5 shows that the share of debt maturing in less than a year has jumped from about 30 percent to over 40 percent, reaching a proportion last seen in the mid-1980s.

Treasury inflation-protected securities, or TIPS, were first introduced in 1997 for notes and in 1998 for bonds. In nominal terms, they have increased from \$24.4 billion in 1997 to \$531.9 billion in June, 2009. However, as a share of total public debt, they are still quite small. Figure 6 shows that TIPS have grown in importance over the last 12 years but still account for less than 10 percent of total debt issues.

Figure 7 show the share of U.S. public debt held by foreign creditors. The foreign share was essentially zero up until the early 1960s. Even by the late 1960s, the foreign share accounted for less than 5 percent of total public debt. It then started rising, reaching 19.9 percent in 1978, in

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public in 2008. The public includes the Federal Reserve Banks whereas the private-investors category does not. Inflation-indexed securities are excluded from the calculation of maturity length.

<sup>12</sup>See, for example, Calvo and Guidotti (1992).

<sup>13</sup>When we regress log maturity on the log debt/GDP ratio and correct for serial correlation, we find that the correlation between maturity length and debt/GDP over the period 1946-2008 is 0.7 and highly significant. The same holds for the early period 1946-1991. Interestingly, the correlation is insignificant over the more recent period of 1992-2008.

part because of recycled OPEC surpluses. The foreign share has risen dramatically in recent years, particularly after the 1997-98 Asian financial crisis, and accounted for 48.2 percent of publicly-held debt in 2008.<sup>14</sup> Mainland China and Japan each held about 10 percent of U.S. public debt at the end of 2008.

Figure 8 illustrates that Mainland China and Japan are the major foreign holders of U.S. public debt. Together they held about 44 percent of total foreign holdings of U.S. public debt at the end of June, 2009. China held \$776.4 billion of U.S. public debt, 23 percent of total foreign holdings, while Japan held \$711.8 billion, or 21 percent of total foreign holdings. In 2008, about 70 percent of all foreign holdings were at foreign central banks.

We next investigate the impact of various inflation scenarios on the real value of the debt and on the debt/GDP ratio. Suppose creditors purchase  $X$  dollars of government debt with a nominal interest rate of  $i$  percent and the debt has  $m$  years until maturity. Suppose  $n$  is the number of times the interest rate is compounded per year, and let the compounding period be infinitesimally small, so that  $n \rightarrow \infty$ . If the annual inflation rate is  $\pi$ , then the real value of the debt after  $m$  years is  $V = Xe^{(i-\pi)m}$ . It follows that the percentage change in the real value of the debt associated with a 1 percent increase in inflation over the life of the debt is  $\partial \log V / \partial \pi = -m$ . The percentage change in the debt/GDP ratio over the period is also  $-m$ .<sup>15</sup> Hence debt maturity ( $m$ ) is key in evaluating the inflation impact. The calculation assumes that maturity is invariant to inflation. This assumption need not always hold, but we assume it does when inflation is

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<sup>14</sup>Analytical Perspectives, Budget of the United States Government, FY2009; U.S. Treasury Bulletin, September 2009; Major Foreign Holders of Treasury Securities ([www.ustreas.gov/tic/mfh.txt](http://www.ustreas.gov/tic/mfh.txt)).

<sup>15</sup> In the discrete version also, the percentage change in the real value of the debt (or the debt/GDP ratio) associated with a 1 percent increase in inflation over the life of the debt can be approximated by  $-m$ , since  $V = X[(1+i)/(1+\pi)]^m$  and  $\partial \log V / \partial \pi = -m/(1+\pi) \approx -m$ .

below some threshold. We later test the validity of this assumption for U.S. data in the post-World War II period.

Figure 9 illustrates the percentage decline in the debt/GDP ratio (or the real value of the debt) of a one-, three-, and five-percent increase in inflation, assuming inflation stays at the higher rate for the life of the debt. Figure 10 pictures the impact of these three inflation scenarios on the share of publicly-held debt over the period 1946-2008. Table A1 in the Appendix shows the actual values of these shares under the three inflation scenarios.

A few observations are worth noting. Inflation yielded the most dramatic reduction in the debt/GDP ratio—and the real value of the debt—in the immediate post-World War II period. A five-percent inflation increase starting in 1946, for example, would have reduced the debt/GDP ratio from 108.6 percent to 59.3 percent, a decline in the debt ratio of 45 percent. The sizeable inflation impact is not that surprising. Not only was there a large debt overhang when the war ended (the publicly-held share of Federal debt was 106 percent of GDP in 1945), but inflation was low (2.3%) and debt maturity was high (over 9 years). Thus there was room to let inflation rise—and it rose to 8.3 percent in 1946, 14.4 percent in 1947, and 8.1 percent in 1948 before dropping considerably. Average inflation over the decade was 4.2 percent. Moreover, long maturities allowed inflation to erode the debt burden. Maturities were over 9 years in years 1945-48 and then fell gradually to 8.75 years in 1949 and 8.17 years in 1950.

In contrast, inflation would have had little impact on reducing the debt burden in the mid-1970s after the initial oil price shocks. That period was characterized by a lower debt overhang (the share of publicly-held share of Federal debt was 23.9 percent of GDP in 1974), inflation was higher (11 percent in 1974), and debt maturities were shorter (under 3 years by 1974 and a mere

2.67 years in 1975). As a result, in 1975 a 5 percent inflation increase would have reduced the debt/GDP ratio from 25.3 percent to 21.9 percent, less than 15 percent.

The estimated impact of inflation on today's debt/GDP ratio is larger than in the mid-1970s but not as large as in the mid-1940s. Had inflation been 3 percent higher in FY2009 and stayed at that higher level over the average life of the debt (3.9 years in 2009), the effective debt/GDP ratio would be about 12 percent lower. Had inflation been 5 percent higher, the debt/GDP ratio would be about 20 percent lower, a debt ratio of 43.4 percent instead of 53.8 percent.

Figure 11 shows how a 3 percent increase in inflation would be shared between domestic and foreign holders of U.S. federal debt. In the 1960s, foreigners held so little debt that essentially the entire burden of higher inflation would fall on U.S. creditors. By the end of 2008, foreigners held almost half of the debt, so higher inflation would be shared about equally between domestic and foreign creditors.

Our computations of the impact of inflation on the debt overhang assume that all debt is denominated in domestic currency, none is indexed, and the maturity is invariant to inflation. While the first two assumptions are sensible (U.S. public debt is 100 percent dollar-denominated and over 90 percent non-indexed), the latter assumption about the responsiveness of maturities to inflation needs further investigation.

Over the period 1946-2008, the simple correlation between U.S. debt maturities and consumer price inflation is -0.296, suggesting higher inflation is associated with lower debt maturities. However, regression results do not support this view.

Table 1 reports the results of linear regressions that examine the relationship in U.S. data between debt maturity and inflation, taking into account that debt maturity may also be

influenced by the amount of debt held by the public as a share of GDP, the share of government spending in GDP, and the GDP growth rate. Over the period 1946-2008, there is a robust positive and significant relationship between debt maturity and the debt/GDP ratio, but there is no significant relationship between debt maturity and inflation. Even when we experiment with various inflation lags, inflation does not influence the maturity of U.S. debt.<sup>16</sup> In the table, we report an example with inflation and one-period lagged inflation as regressors; both inflation variables are insignificant. Thus, the assumptions invoked to compute the impact of inflation on the debt overhang seem to be reasonable.<sup>17</sup>

### III. A Model and Simulations

We describe a stylistic model that illustrates both costs and benefits associated with inflating away some of the debt burden. The model shows that the foreign share of the nominal debt is an important determinant of the optimal inflation rate. So is the size of the debt/GDP ratio, the share of debt indexed to inflation, and the cost of collecting taxes.

We consider an infinite-horizon economy that starts in period one with a public debt overhang. Previous inflation was low, say zero, such that a significant share of the public debt is not indexed to inflation. The average debt maturity is long enough to allow the authorities to contemplate unanticipated inflation as a way to erode the real debt. An inflation-inducing policy

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<sup>16</sup>Missale and Blanchard (1994) found that during the 1960-1989 period, the debt/GDP ratio dominated inflation, both quantitatively and statistically, in its influence on debt maturity in three countries, Ireland, Italy, and Belgium; inflation only significantly decreased maturity for two of them, Ireland and Italy.

<sup>17</sup> Figure 4 suggests that the positive and significant correlation between debt maturities and the debt/GDP ratio may have broken down after the early 1990s, raising the question of whether the relationship between maturities and inflation may also have changed. Indeed, there is no significant correlation between maturities and either debt ratios or inflation when the regression is run over the sub-sample 1992-2008. However, the sample size is small. When we regress over the full period 1946-2008, interacting a dummy variable for the 1992-2008 sub-period with both the debt ratio and inflation and also including it as a shift parameter, we find that the strong positive and significant relationship between maturities and the debt ratio is maintained, though reduced by a small 1.5 percent in the more recent period, and there is no significant difference in the relationship between maturities and inflation across periods.

is costly, however. It will trigger in the next period the full indexation of the remaining public debt, and it will be associated with a drop in output during the inflationary-disinflationary cycle. The period length coincides with the duration of a business cycle and/or an inflationary-disinflationary cycle (say four years for the U.S.).

To simplify, we assume away growth. Output in the absence of an inflationary-disinflationary cycle is  $\bar{Y}$ . The initial outstanding debt in period one (the first period debt overhang) is  $b\bar{Y}$ . A fraction  $\theta$  of the debt is de-facto indexed to inflation -- either due to formal indexation (like TIPS) or to having almost instantaneous maturity.

The real interest rate in the absence of unanticipated inflation is determined by global conditions and is assumed to be exogenously given at level  $r$ . The rate is also the real interest rate on the indexed bonds. Hence, an unanticipated inflation rate of  $\pi > 0$  in period one will reduce the real value of outstanding debt at the end of period one to  $b \frac{(1-\theta)\bar{Y}}{1+\pi}$ .

A fraction  $(1-f)$  of the initial debt is held by economic domestic actors,  $f$  by foreign economic actors. To simplify, we assume a symmetric ownership share of the indexed debt between domestic and foreign economic actors.

The penalty on attempts to inflate the debt in period one is that the remaining value of debt becomes real debt in period two and throughout the indefinite future – inflation in period one will induce private lenders to demand formal indexation or a sharp shortening of the maturity.

Output depends negatively on inflation:

$$(1) \quad Y = \bar{Y}(1 - h\pi^\phi); \quad \phi \geq 1.^{18}$$

The output is taxed at a rate  $t$ . For simplicity, the tax rate is set in period one and stays fixed for the indefinite future. Taxes are associated with deadweight losses, modeled in reduced form as a tax collection cost,  $\tau$ . A tax rate  $t$  provides the authorities with net tax revenue of

$Y(t - 0.5\tau t^2)$ .<sup>19</sup> These assumptions imply that if the authorities inflate in period one, they have the incentive to return to zero inflation for the indefinite future.

The consumer's utility is

$$(2) \quad U_1 = \log C_1 + \beta \log C_2 + \dots \beta^{s-1} \log C_s + \dots$$

The domestic consumer's financial wealth at the beginning of period one is

$$(3) \quad (1 - f)b\bar{Y} = A_1$$

The second period initial asset position of the domestic consumer is:

$$(4) \quad \left[ (1 - f)b\bar{Y} \left( \theta + \frac{1 - \theta}{1 + \pi} \right) + \bar{Y}(1 - h\pi^\phi)(1 - t) - C_1 \right] (1 + r) = A_2.$$

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<sup>18</sup> Recalling that the period length coincides with the duration of an inflationary-disinflationary cycle, the values of  $h$  and  $\phi$  capture the average output cost and indirectly the welfare cost of such a cycle. While, to our knowledge, there are no recent estimates of these values, Friedman (1985) estimated that the cost of 5 percentage points of disinflation over the 1980-1988 period was 20 point-years of unemployment, for a final trade-off of 4-to-1, toward the pessimistic end of Okun's range. He noted that it was possible to construct a more favorable picture on the basis of more optimistic assumptions, for a final trade-off of 2-1, about at the optimistic end of Okun's range.

<sup>19</sup> Like Barro (1979), we model these tax collection costs as a non-linear share of output and let them depend positively on the tax rate.

Assuming that anticipated first-period inflation is zero, a positive inflation in period one implies that all debt in the future will be indexed. The budget constraint in period  $s$ ,  $s > 1$ , will be:

$$(5) \quad [A_s + Y_s(1-t) - C_s](1+r) = A_{s+1}.$$

Forward iterations imply that the intertemporal budget constraints can be reduced to:

$$(6) \quad (1-f)b\bar{Y}\left(\theta + \frac{1-\theta}{1+\pi_1}\right) + \bar{Y}(1-h\pi_1^\phi)(1-t) + \sum_{s=1}^{\infty} \frac{\bar{Y}(1-t)}{(1+r)^s} = \sum_{s=1}^{\infty} \frac{C_s}{(1+r)^{s-1}}.$$

The left-hand side of Equation (6) is first-period wealth. The representative consumer maximizes utility subject to the intertemporal budget constraint, where the net present value of the consumption stream equals the consumer's first period wealth:

$$W_1 = (1-f)b\bar{Y}\left(\theta + \frac{1-\theta}{1+\pi_1}\right) + \bar{Y}\left(1-h\pi_1^\phi + \frac{1}{r}\right)(1-t)$$

Assuming an exogenously given interest rate, it follows that the resulting utility is proportional to initial wealth.

The policy maker will set the inflation rate and the tax rate in order to maximize the representative consumer's first-period wealth, subject to the fiscal intertemporal budget constraint. We assume an exogenous fiscal expenditure of  $g\bar{Y}$  each period. Hence, the fiscal intertemporal budget constraints are:

$$(7) \quad \left[ b\bar{Y}\left(\theta + \frac{1-\theta}{1+\pi_1}\right) + g\bar{Y} - \bar{Y}(1-h\pi_1^\phi)(t-0.5\tau t^2) \right] (1+r) = D_2^g;$$

$$\left[ D_s^g + g\bar{Y} - \bar{Y}(t-0.5\tau t^2) \right] (1+r) = D_{s+1}^g; \quad s > 1$$

where  $D_s^g$  is the real public debt at the beginning of period  $s$ . Forward iterations provide the following intertemporal fiscal constraint:

$$(8) \quad b\bar{Y}\left(\theta + \frac{1-\theta}{1+\pi_1}\right) + g\bar{Y}\left(1 + \frac{1}{r}\right) = \bar{Y}\left(1 - h\pi_1^\phi + \frac{1}{r}\right)(t - 0.5\tau t^2).$$

Alternatively,

$$(9) \quad t - 0.5\tau t^2 = \Gamma, \quad \text{where } \Gamma = \frac{b\left(\theta + \frac{1-\theta}{1+\pi_1}\right) + g\left(1 + \frac{1}{r}\right)}{1 - h\pi_1^\phi + \frac{1}{r}}$$

The left-hand side of (9) is the flow of taxes per dollar income net of collection costs. It should cover the “long run” fiscal expense share of the GDP, namely  $\Gamma$ . In the absence of inflation and debt overhang, the right-hand side of (9) is simply  $g$ . If  $g$  is zero, then in the absence of inflation the right-hand side is the annuity value of the public debt overhang as a fraction of permanent output,  $\frac{r}{1+r}b$ .

The fiscal budget constraint provides the tax Laffer curve:

$$(10) \quad t(\pi_1; \theta, g, r, h, \tau) = \frac{1 - \sqrt{1 - 2\tau\Gamma}}{\tau}.$$

The policy maker sets the inflation rate so as to maximize the consumer's wealth, ( $W_1$ ), subject to the Laffer curve constraint, (10). Specifically, the policy maker's problem is:

$$\text{MAX}_{\pi_1} \left[ (1-f)b\bar{Y} \left( \theta + \frac{1-\theta}{1+\pi_1} \right) + \bar{Y} \left( 1 - h\pi_s^\phi + \frac{1}{r} \right) \{1-t(\pi_1)\} \right]$$

It follows that for an internal equilibrium -- one with positive inflation -- we get:

$$\begin{aligned} \pi^* &= \pi(b, f, \tau, g, \theta); \quad \pi'_b > 0, \pi'_f > 0, \pi'_\tau > 0, \pi'_g > 0, \pi'_\theta < 0 \\ t^* &= t(b, f, \tau, g, \theta); \quad t'_b > 0, t'_f < 0, t'_\tau < 0, t'_g > 0, t'_\theta > 0 \end{aligned}$$

Higher debt overhang (a higher debt/GDP ratio,  $b$ ) increases the incentive to inflate in the first period in order to reduce the deadweight losses associated with conventional taxes. A greater foreign share of the debt overhang ( $f$ ) increases the attractiveness of the inflation tax since it increases the share of the tax paid by foreign lenders. Less efficient tax collection (bigger  $\tau$ ) increases the gain associated with the inflation tax. Higher fiscal expenditure ( $g$ ) is associated with a higher tax rate  $t$  as well as higher inflation. Higher indexation ( $\theta$ ) reduces the efficacy of inflation as an implicit tax, thereby increasing the explicit tax rate,  $t$ .

Figure 12 summarizes a simulation of the model for parameter values comparable to today's experience. The initial debt overhang is set at  $b=0.5$ , the share held by foreign creditors is  $f=0.5$ , and fiscal expenditures as a share of GDP is  $g=0.25$ . In addition, average annual debt maturities are set at  $m=4$ , the share of indexed bonds at  $\theta=0.10$ , and the annual real interest rate at  $r=0.01$ . Finally, we (somewhat arbitrarily) set the tax collection cost at  $\tau=0.25$

(implying that 4 cents of each dollar in gross tax payments covers collection costs when the tax rate is  $t=0.30$ ).

A simulation with these parameter values suggests that positive low inflation significantly reduces the debt overhang. For example, a 6 percent inflation rate reduces the public debt/GDP ratio from 50 percent to about 40 percent within 4 years.

Applying parameter values that duplicate the 1946 experience to the base model ( $b = 1.1$ ,  $g = .25$ ,  $f = 0$ ,  $\theta = 0$ ,  $r = 0.01$ , and  $m = 9$ ) results in an inflation rate around 3 percent. This inflation rate is below the 4.2 percent average inflation observed over the decade 1946-1955, but not by much.

One problem is that the simulation is hampered by not having accurate values for deadweight losses associated with income taxes and inflation, and these costs may differ today compared to the 1940s.<sup>20</sup> To illustrate, suppose the cost of inflation was lower in the aftermath of World War II. Figure 13 shows the relationship between projected inflation after World War II and the cost of inflation,  $\phi$ , where a higher  $\phi$  is associated with a lower inflation cost. The earlier simulation assumed  $\phi = 1.15$ . Increasing  $\phi$  to 1.4 would increase predicted inflation in the aftermath of World War II to about 6 percent, above the average inflation for the decade 1946-1955 but about equal to the rate observed over the shorter 1946-1952 period. Of course, this example suggests that if the cost of inflation and other structural parameters are not stable over time, intertemporal comparisons are problematic.

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<sup>20</sup> In the model, the cost of inflation is  $1 - h\pi^\phi$ . If  $h=1$  and  $\phi=1.15$ , an inflation of 5 percent is associated with an output cost during the inflation-disinflation cycle of about 3 percent of GDP. The inflation rate predicted by the model depends critically on the assumed inflation cost. Above some threshold inflation, these costs may arguably accelerate. In another context, Bruno and Easterly (1998) show that the cost of inflation increases above some threshold.

#### IV. Conclusion

A lesson to take from the model and the simulations is that eroding the debt through inflation is not farfetched. The model predicts that a moderate inflation of 6 percent could reduce the debt/GDP ratio by 20 percent within 4 years. That inflation rate is only slightly higher than the average observed after World War II. Of course, inflation projections would be much higher than 6 percent if the share of publicly-held debt in the U.S. were to approach the 100 percent range observed at the end of World War II. Hence, while moderate inflation may help reduce today's debt burden, it is a much less powerful tool for addressing long-term fiscal challenges.

The current period shares two features with the immediate post-war period. It starts with a large debt overhang and low inflation. Both factors increase the temptation to erode the debt burden through inflation.

Even so, there are two important differences between the periods. Today, a much greater share of the public debt is held by foreign creditors—48 percent instead of zero. This large foreign share increases the temptation to inflate away some of the debt.<sup>21</sup> Another important difference is that today's debt maturity is less than half what it was in 1946—3.9 years instead of 9. Shorter maturities reduce the temptation to inflate. These two competing factors appear to offset each other, and the net result in a simple optimizing model is a projected inflation rate slightly higher than that experienced after World War II, but for a shorter duration.

In the model simulation, we raised a concern about the stability of some parameters across periods, particularly the parameters that capture the cost of inflation. It may be that the cost of inflation is higher today because globalization and the greater ease of foreign direct

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<sup>21</sup> Figure 12 suggests that if all debt today were held by domestic creditors ( $f=0$ ), projected inflation would be zero. Thus, 'tax your neighbor' is a key feature of the inflationary bias suggested by the model. Of course, with a higher debt/GDP ratio approaching IMF estimates of  $b=1$ , inflation could be positive even with  $f=0$ .

investment provide new options for producers to move activities away from countries with greater uncertainty. Inflation above some threshold could generate this uncertainty, reducing further the attractiveness of using inflation to erode the debt.

Moreover, history suggests that a modest inflation may increase the risk of an unintended inflation acceleration to double digit levels, as happened in 1947, and in 1979-1981. Such an outcome often results in an abrupt and costly adjustment down the road.<sup>22</sup> Accelerating inflation had limited global implications at a time when the public debt was held domestically and the U.S. was the undisputed global economic leader. In contrast, unintended acceleration of inflation to double digit levels in the future may have unintended adverse effects, including growing tensions with global creditors and less reliance on the dollar.<sup>23</sup>

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<sup>22</sup> Such a cycle is also politically costly because U.S. savers are exposed to another volatile cycle in their retirement and savings accounts.

<sup>23</sup> For the threat to the dollar from the Euro, see Chinn and Frankel (2008).

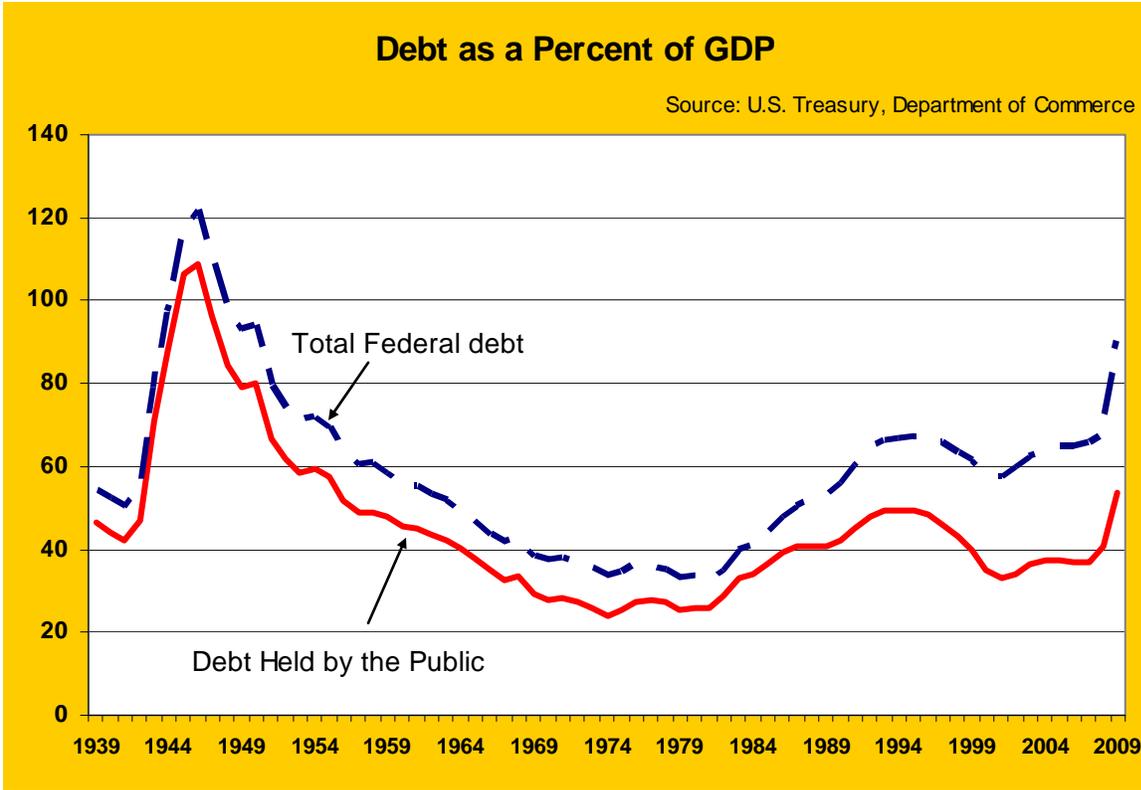


Figure 1: Debt as a Share of GDP

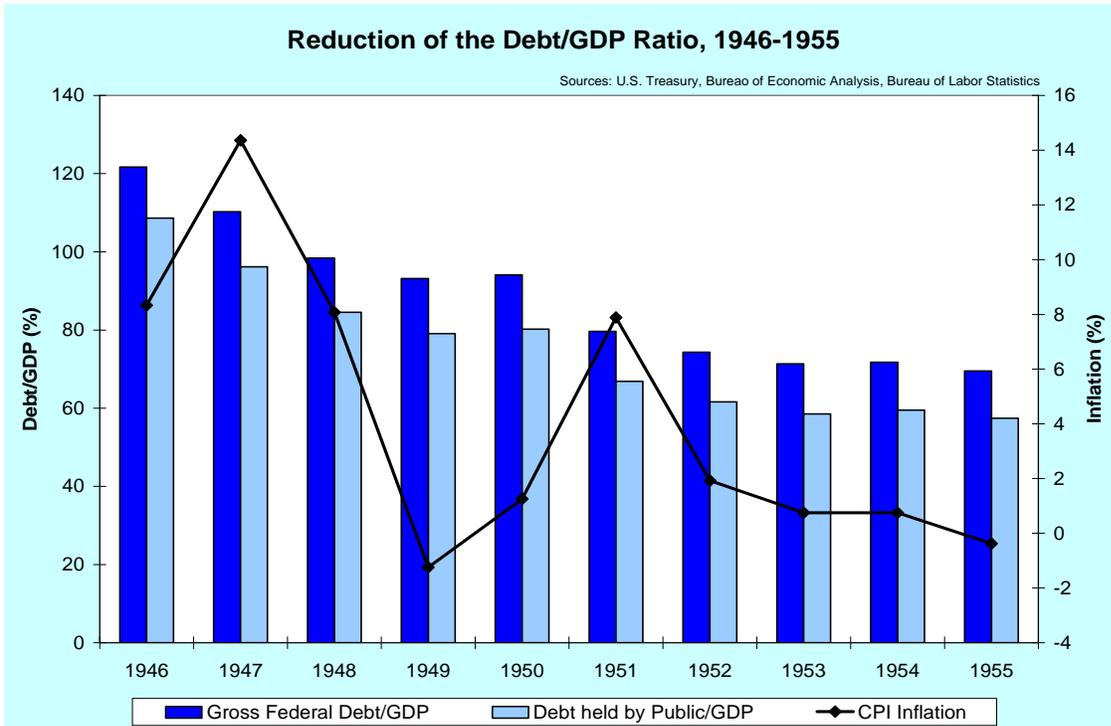


Figure 2: U.S. Debt Reduction, 1946-1955

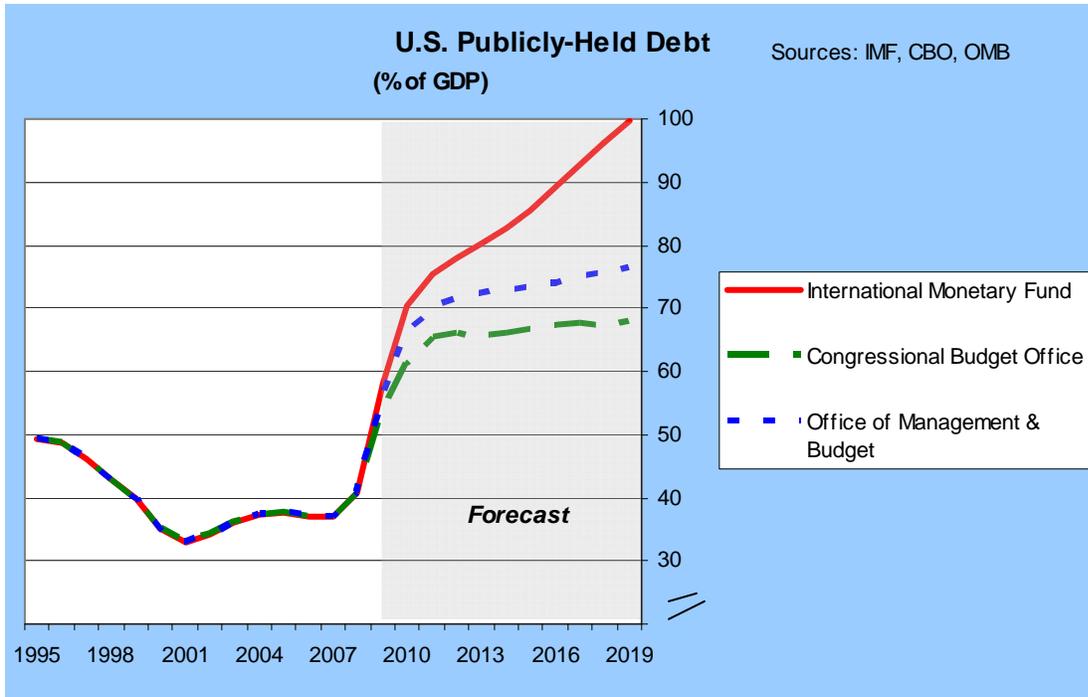


Figure 3: America's Projected Debt Burden

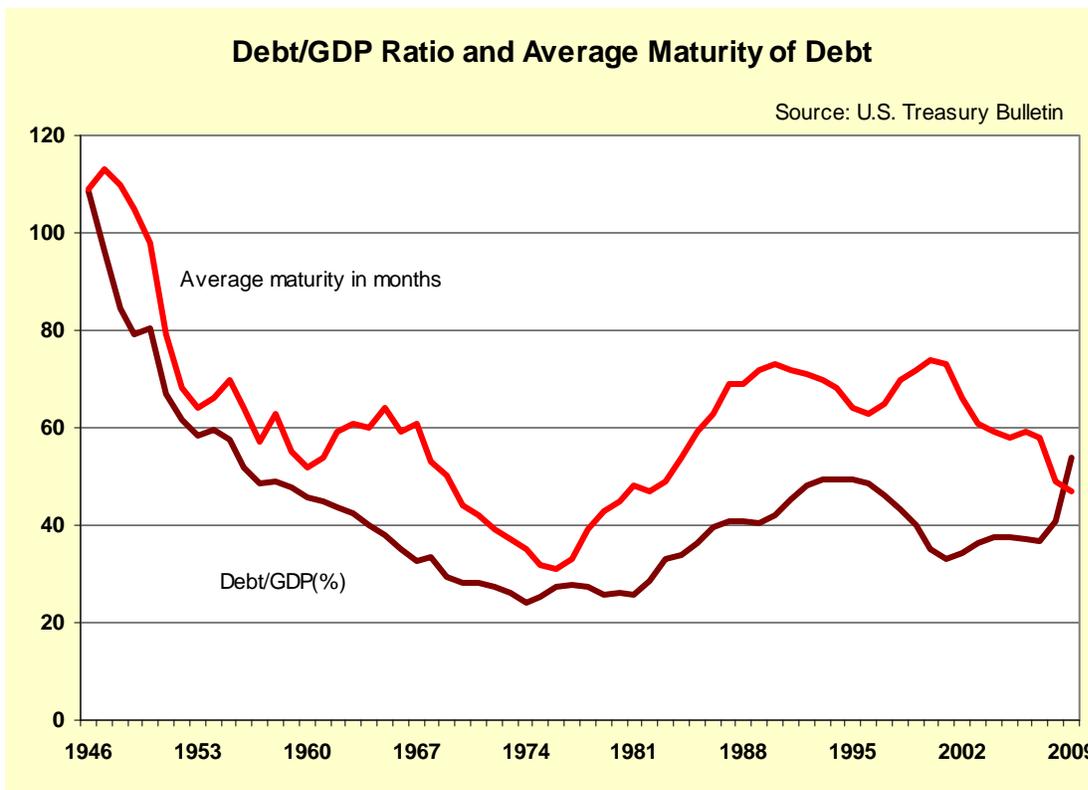


Figure 4: Average Maturity Length and Share of Debt Held by the Public

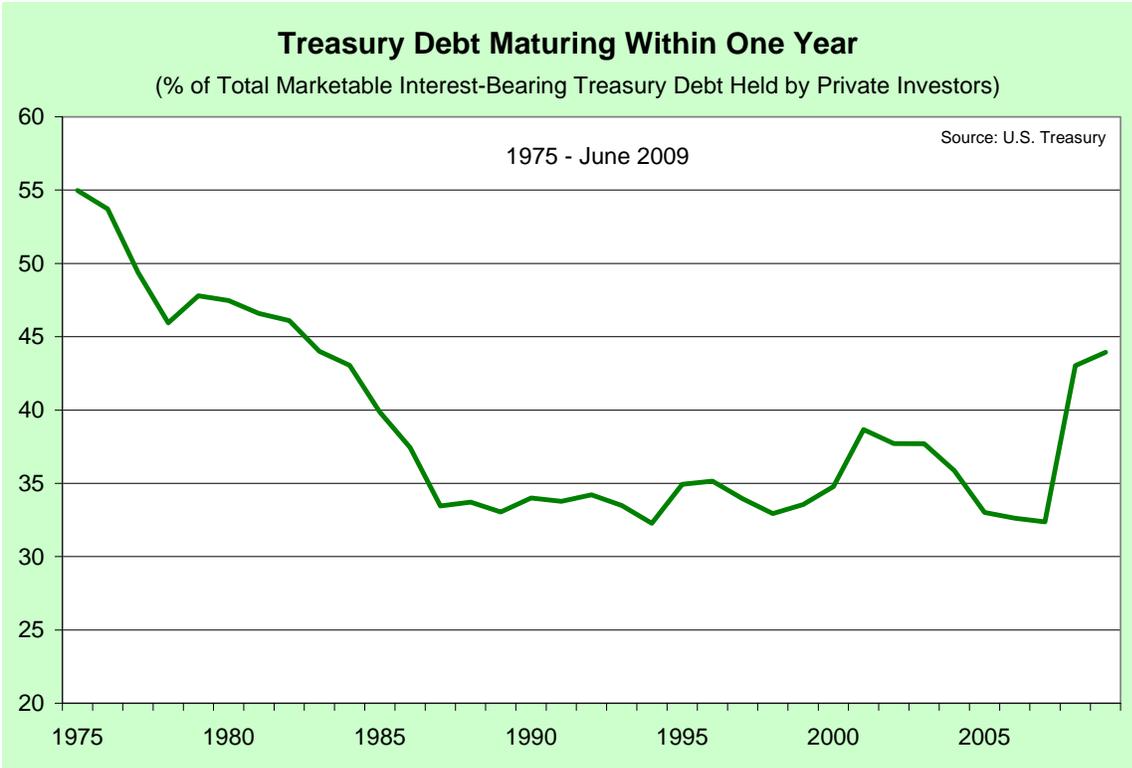


Figure 5: Debt Maturing Within One Year

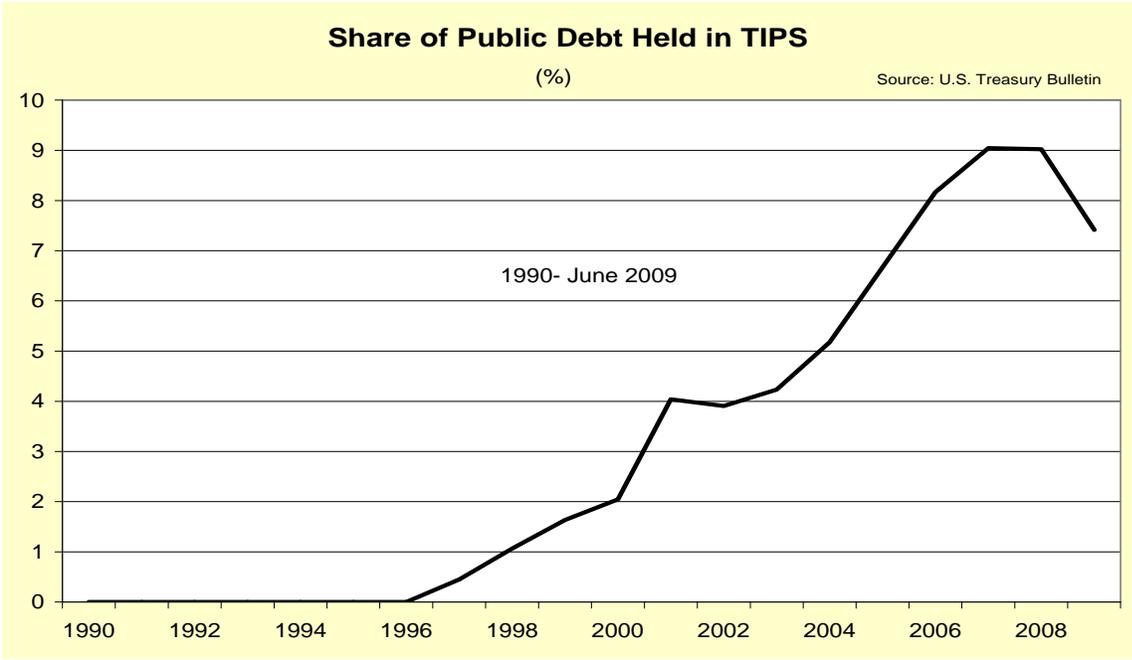


Figure 6: Share of Public Debt Held in TIPS (Treasury Inflation-Protected Securities)

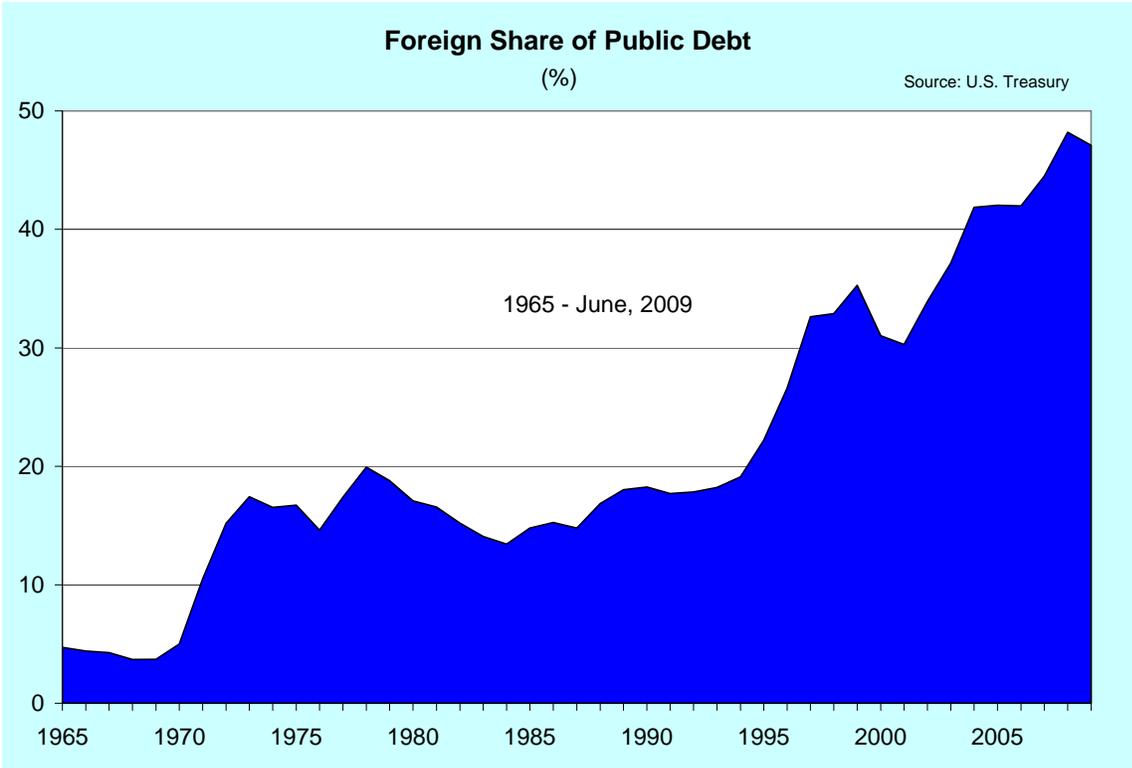


Figure 7: Foreign Share of Publicly-Held Federal Debt

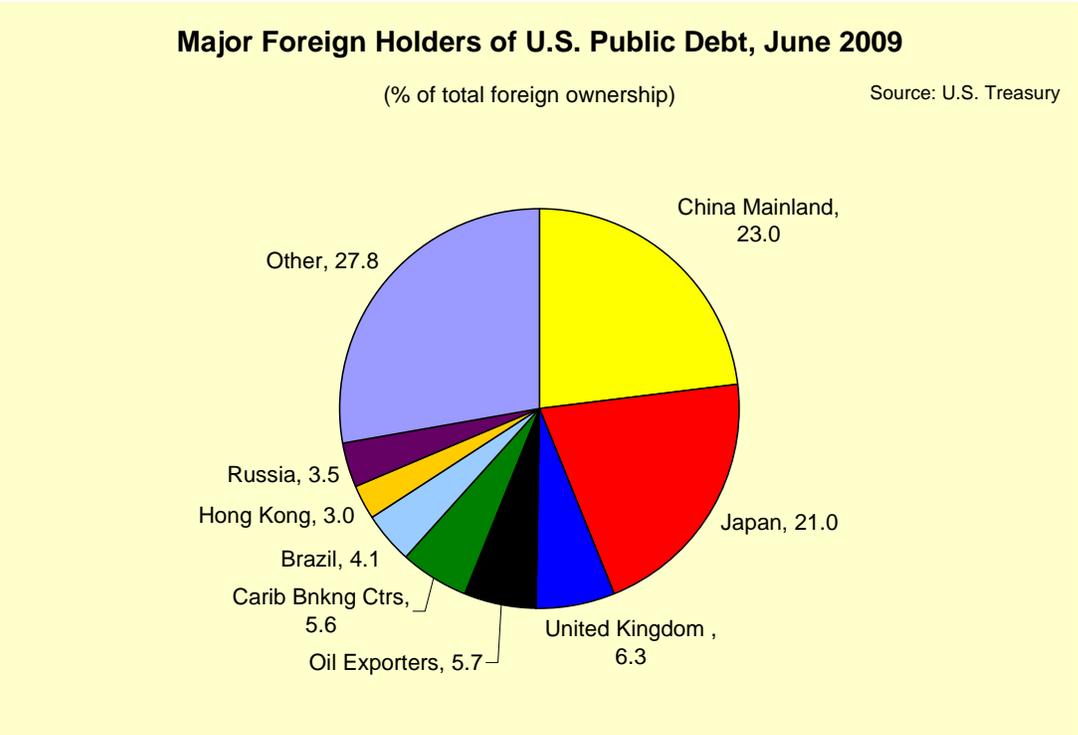


Figure 8: Major Foreign Holders

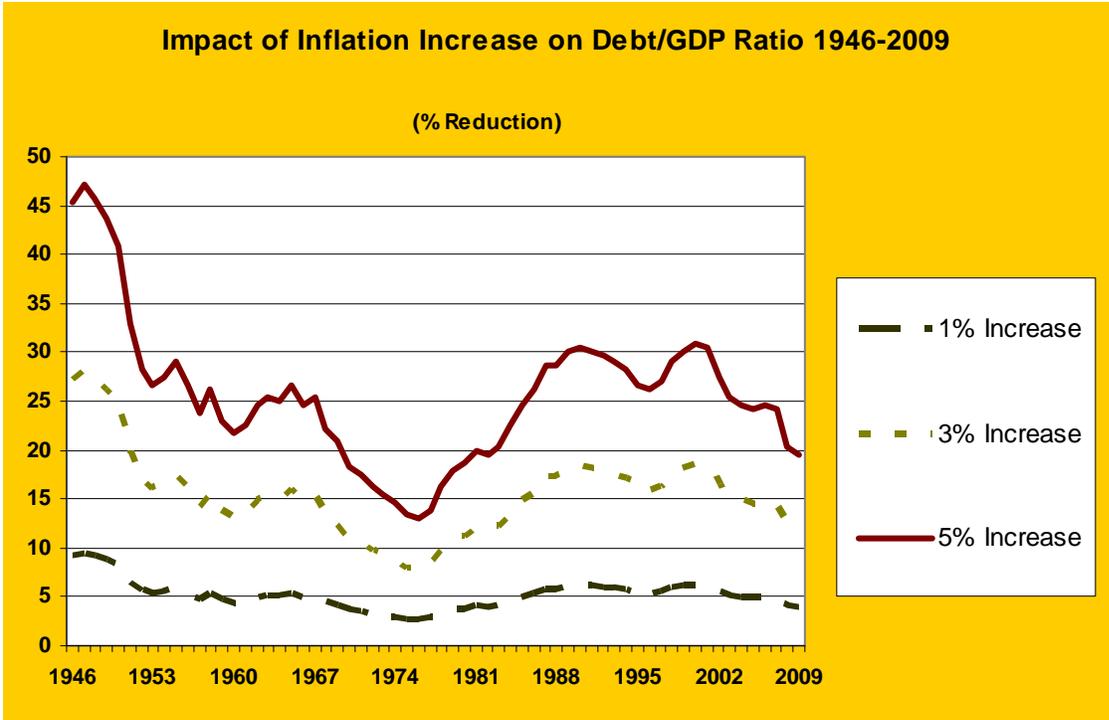


Figure 9: Impact of Inflation on Publicly-Held Debt as a Share of GDP

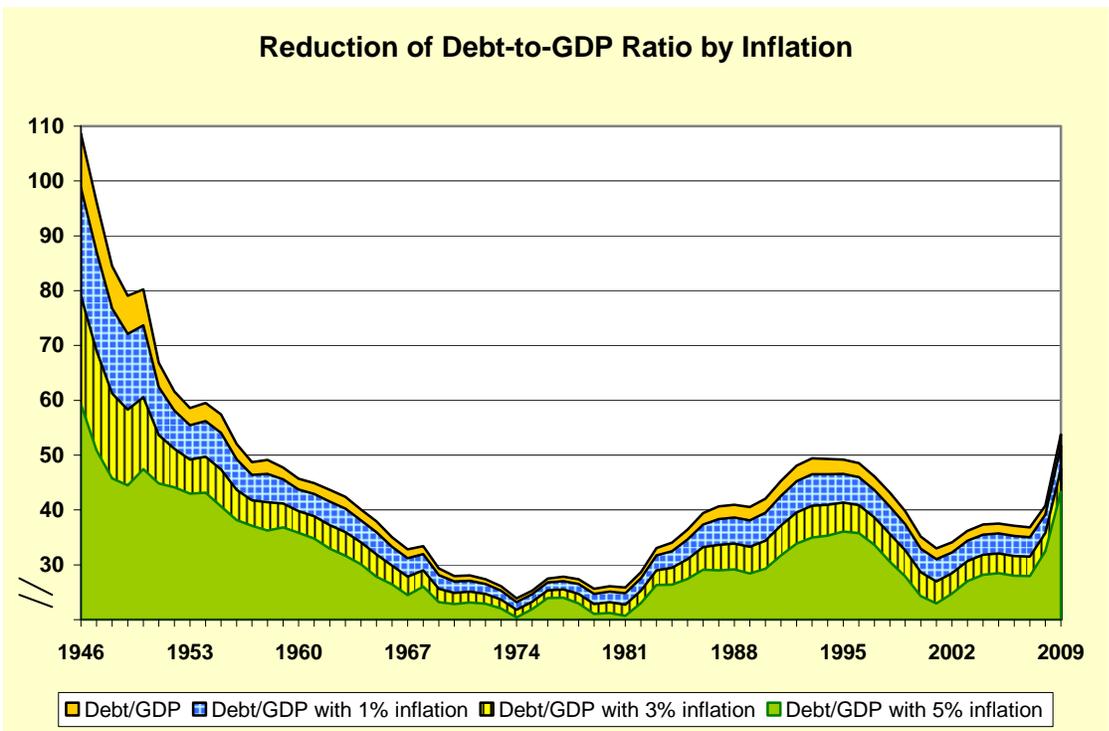


Figure 10: Share of Debt held by Public under Various Inflation Scenarios

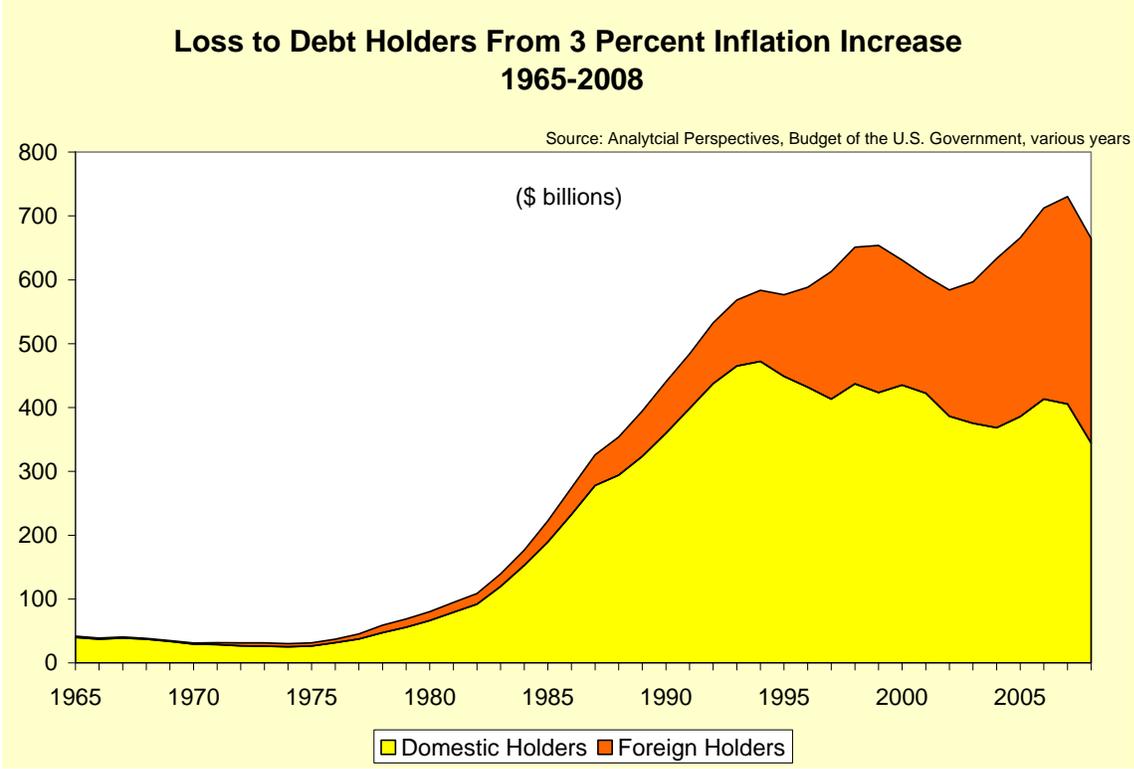
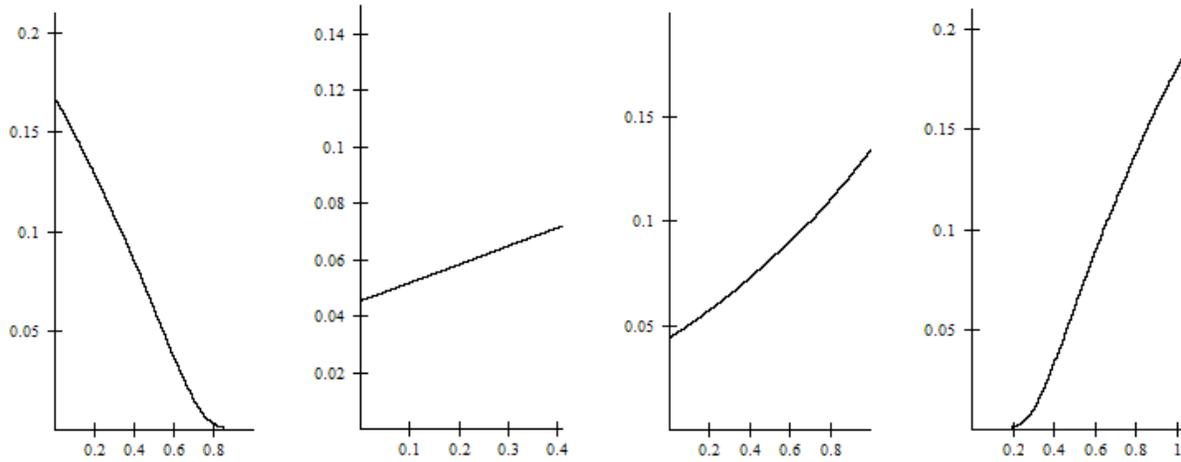
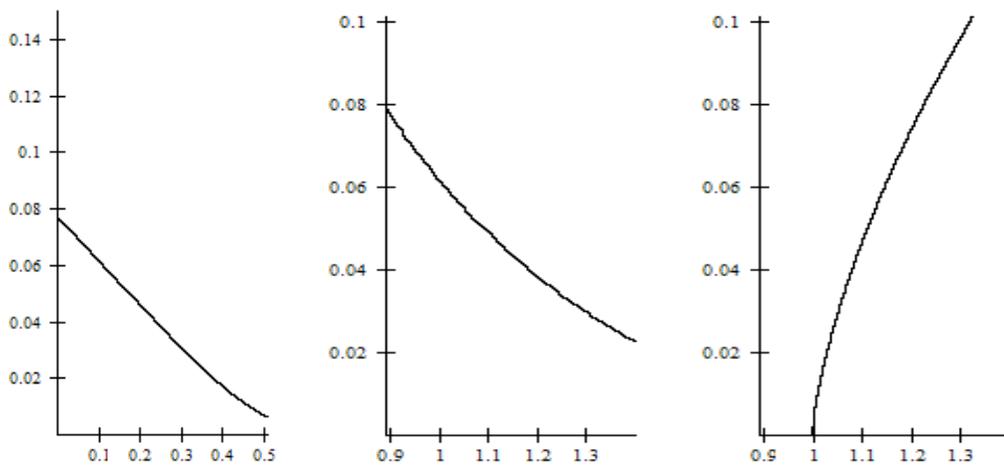


Figure 11: Loss to Domestic and Foreign Debt Holders



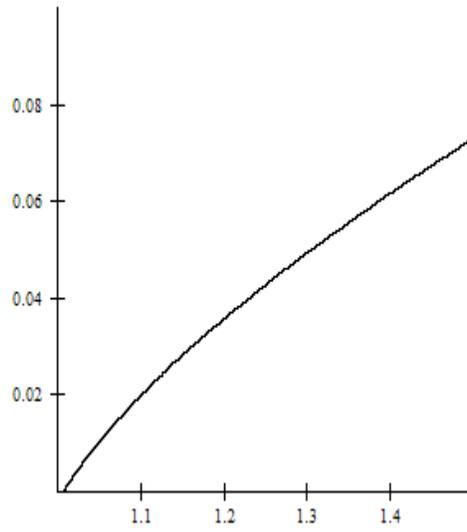
Domestic share =  $1 - f$ ; Fiscal expenditure share,  $g$ ; Collection cost,  $\tau$ ; Public Debt/GDP,  $b$



Share of indexed debt,  $\theta$ ; Inflation cost parameter,  $h$ ; Inflation cost parameter,  $\phi$

The simulation baseline assumptions are:  $m = 4$ ,  $b = 0.5$ ,  $f = 0.5$ ,  $g = 0.25$   
 $r = 0.01$ ,  $\theta = 0.1$ ,  $\tau = 0.25$ ,  $\phi = 1.15$ , and  $h = 1$ .

Figure 12: Association Between Predicted Inflation and Parameter Values



Note: Inflation rate calibrated for 1946. Lower inflation cost increases cost parameter  $\phi$ .

Figure 13: Association between Inflation and Inflation Cost Parameter  $\phi$

Table 1: Debt Maturity and Inflation, 1946-2008

VARIABLES	(1) maturity	(2) maturity	(3) maturity	(4) maturity	(5) maturity	(6) maturity
debt/GDP	0.711*** [0.134]	0.710*** [0.144]	0.680*** [0.152]	0.694*** [0.122]	0.694*** [0.124]	0.740*** [0.115]
inflation		-0.000610 [0.0461]	0.0242 [0.0419]	-0.0451 [0.0398]	-0.0454 [0.0437]	-0.0183 [0.0366]
infla lagged			-0.0459 [0.0406]			
g/GDP				0.594* [0.350]	0.593 [0.356]	0.0165 [0.345]
growth					-0.000409 [0.00912]	-0.00320 [0.00771]
trend						0.00545*** [0.00182]
Constant	-1.036** [0.496]	-1.032* [0.558]	-0.897 [0.601]	-2.705** [1.334]	-2.697* [1.367]	-1.445 [1.120]
Observations	55	55	55	55	55	55

Newey-West standard errors with second-order autocorrelation correction in brackets.

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1. All variables in logs except trend and GDP growth.

## Appendix

Table A1: Impact of Inflation on the Share of Publicly-Held Debt

Year	Debt/GDP Actual	Debt/GDP 1% inflation	Debt/GDP 3% inflation	Debt/GDP 5% inflation
1946	108.6	98.8	79.0	59.3
1947	96.2	87.1	69.0	50.9
1948	84.5	76.7	61.3	45.8
1949	79.0	72.1	58.3	44.5
1950	80.2	73.7	60.6	47.5
1951	66.8	62.4	53.6	44.8
1952	61.6	58.1	51.1	44.2
1953	58.6	55.4	49.2	42.9
1954	59.5	56.2	49.7	43.1
1955	57.4	54.1	47.4	40.7
1956	52.0	49.2	43.7	38.1
1957	48.7	46.4	41.8	37.1
1958	49.1	46.6	41.4	36.2
1959	47.8	45.6	41.2	36.8
1960	45.7	43.7	39.8	35.8
1961	44.9	42.9	38.9	34.8
1962	43.7	41.5	37.2	33.0
1963	42.4	40.3	36.0	31.6
1964	40.1	38.1	34.1	30.1
1965	38.0	35.9	31.9	27.8
1966	35.0	33.3	29.9	26.4
1967	32.8	31.2	27.8	24.5
1968	33.4	31.9	29.0	26.0
1969	29.3	28.1	25.7	23.2
1970	28.0	27.0	24.9	22.8
1971	28.1	27.1	25.1	23.1
1972	27.4	26.5	24.7	22.9
1973	26.1	25.3	23.7	22.1
1974	23.9	23.2	21.8	20.4
1975	25.3	24.6	23.3	21.9
1976	27.5	26.8	25.4	23.9
1977	27.8	27.0	25.5	24.0
1978	27.4	26.5	24.7	22.9
1979	25.6	24.7	22.9	21.0
1980	26.1	25.1	23.2	21.2
1981	25.8	24.8	22.7	20.7
1982	28.6	27.5	25.3	23.0
1983	33.1	31.7	29.0	26.3
1984	34.0	32.5	29.4	26.4
1985	36.4	34.6	31.0	27.4
1986	39.4	37.4	33.2	29.1
1987	40.7	38.3	33.7	29.0

1988	41.0	38.6	33.9	29.2
1989	40.6	38.1	33.3	28.4
1990	42.0	39.5	34.4	29.3
1991	45.3	42.6	37.2	31.7
1992	48.1	45.2	39.5	33.9
1993	49.4	46.5	40.8	35.0
1994	49.3	46.5	40.9	35.3
1995	49.2	46.6	41.3	36.1
1996	48.5	46.0	40.9	35.8
1997	46.1	43.6	38.6	33.6
1998	43.1	40.6	35.6	30.5
1999	39.8	37.4	32.6	27.9
2000	35.1	33.0	28.6	24.3
2001	33.0	31.0	27.0	23.0
2002	34.1	32.2	28.5	24.7
2003	36.2	34.4	30.7	27.0
2004	37.4	35.5	31.8	28.2
2005	37.5	35.7	32.1	28.5
2006	37.1	35.3	31.6	28.0
2007	36.8	35.1	31.5	27.9
2008	40.8	39.1	35.8	32.5
2009	53.8	51.7	47.5	43.3

## A.2 Debt Reduction After the American Revolution and the Civil War

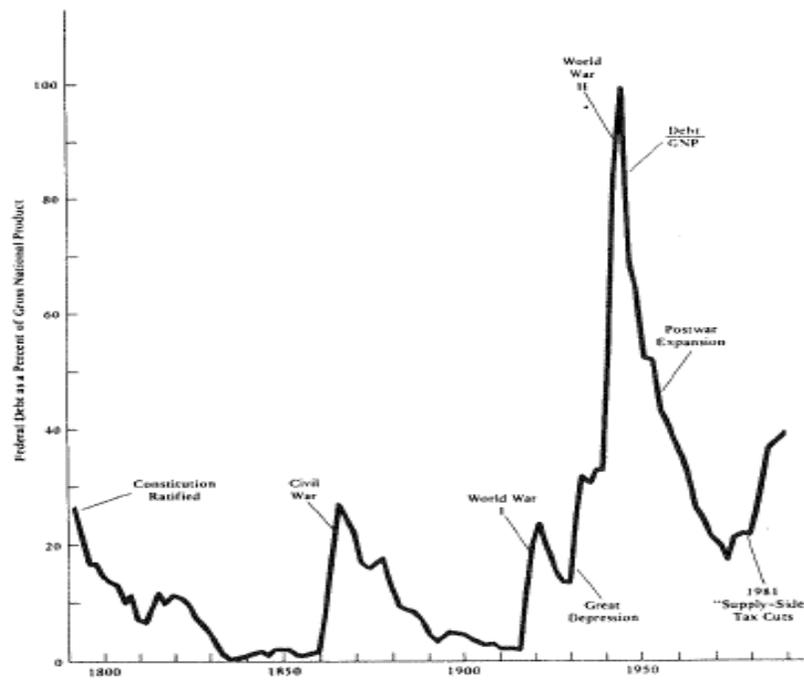


Figure A.1: Government Debt Since the American Revolution  
Source: Stabile and Cantor (1991)

## I. *The American Revolutionary War Period (1775-1801)*

Figure A.1, taken from Stabile and Cantor (1991, p. 2), shows the growth of Federal debt as a share of GNP from 1790 to 1990. Although GNP figures are suspect before 1840, the date of the first census, the graph clearly illustrates the large increase in the debt/GNP ratio during wartime and the large decline afterwards.

In this Appendix, we briefly examine the American Revolutionary War (1776-1781) and the Civil War (1861-1865) periods and ask to what extent inflation helped erode the debt/GDP ratio in the aftermath of these wars. We find that inflation played virtually no role. Instead, GNP growth and tariff revenue applied to redeeming debt principal and interest reduced the debt ratio in the aftermath of these major conflicts.

*Revolutionary War Period.* The Congress and the states financed most of The War of Independence (1776-1781) by issuing paper money, resulting in a rapid inflation and currency depreciation. Although the war was about 85 percent financed by money printing, the government also borrowed funds, mostly from its own citizens, though the French government and Dutch investors also provided some loans.

The U.S. Congress first started borrowing in October, 1776. The interest rate offered was 4 percent, payable in specie or its equivalent in foreign bills of exchange, and the certificates had a 3-year maturity. In February, 1777, to attract investors, the interest rate was raised to 6 percent and the new securities had no fixed maturity dates. The 3-year certificates previously issued were not retired on schedule, since redemption funds were nonexistent; instead, they were converted into open-ended obligations as well. In March 1778, the offer to pay interest in specie was withdrawn and holders were promised

interest payments merely in currency.<sup>24</sup> In the 1780s, holders received interest payments in IOUs. Since no one knew when congressional debts would be repaid, or when and in what form interest payments would be forthcoming, the securities traded at large discounts. Even in the mid-1780s, sellers of federal securities received very low prices, often ten to fifteen cents on the dollar.

In 1789, after the ratification of a new Constitution and the inauguration of the first President, Alexander Hamilton was appointed Secretary of the Treasury. He reported to Congress in January, 1790. He stated that the federal domestic debt was roughly \$40 million, consisting of \$27 million in original principal plus \$13 million in accrued interest. Another \$12 million was owed to foreign creditors.

Hamilton made several recommendations to Congress. He proposed federal assumption of the remaining wartime debts of the states, which would increase the size of the debt by another \$18 to \$25 million (ultimately it was \$18 million, bringing the total federal debt to \$70 million, about 27 percent of GNP). He proposed converting all outstanding debt securities into specie-denominated securities at the official par of exchange. The essence of Hamilton's proposal was to defer repayment of debt principal indefinitely but resume interest payments (the \$13 million in arrears) in specie.

Hamilton believed that it would make little difference to investors that the bonds had no fixed maturity dates as long as the government pledged to maintain regular interest payments. His calculation that funding interest payments would drive up bond prices (close to par) and reduce yields proved correct. To generate the revenues to cover the interest on the national debt, Hamilton proposed a tax program that relied primarily

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<sup>24</sup> During the brief period when interest payments were made in a (depreciating) currency, inflation was able to erode some value to debt holders.

on an import tariff. After much heated debate, Congress passed the Funding Act of 1790 and Hamilton's plan was enacted.<sup>25</sup>

#### B. The Civil War Period (1861-1900)

When the Civil War broke out in 1861, Congress authorized the Treasury to issue Treasury notes (called greenbacks) as legal tender for payment of all public and private debts and also authorized the sale of bonds. Later, it increased taxes on specific goods, but as these taxes were inadequate to raise the necessary funds to fight the war, a continued reliance on money printing and borrowing was unavoidable. Between 1860 and 1865, when the Civil War ended, prices almost doubled. At the end of 1865, interest-bearing debt stood at \$2.7 billion, about 30 percent of GNP, all of it owed to domestic creditors.<sup>26</sup>

With the war over, Congress gave the Secretary of the Treasury authority to convert short-term notes into long-term bonds and begin retiring greenbacks (Bolles, 1886). In 1869, it authorized the payment of all interest-bearing obligations in "hard money"—specie. Tax revenue generated primarily through the import tariff was used to pay interest on the debt and a certain amount of the principal each year. By 1880, the public debt had been reduced substantially (the debt/GNP ratio was under 20 percent), through a combination of economic growth and tax revenue targeted at paying interest and principal on the debt.

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<sup>25</sup> For more on war financing and debt management during the American Revolutionary War period, see Calomiris (1988), Myers (1970), Perkins (1994) and Stabile and Cantor (1991).

<sup>26</sup> After the Civil War, foreigners began purchasing U.S. government debt. By the end of 1866, they held 13 percent of the public debt. By 1869, they held about 48 percent (Stabile and Cantor, 1991).

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