

Temporarily Unstable Government Debt and Inflation--Discussion

- An impressive paper, with full-fledged model and calibration.
- Builds on years of innovative and influential research by Leeper and coauthors.
- Takes some initiation and homework.

A few questions on the model/approach

- Does the model really need to be based on increasing transfers and looming pressures from aging? Wouldn't the results be motivated by any increase in the deficit, regardless of the source?
- How does the paper relate/compare with Drazen and Helpman (REStud, 1990), who make sense of the difficulties in identifying a link between budget deficits and inflation through changes in expectations of how the deficit will be financed (relative shares of inflation versus borrowing).
- How would inflation help solve the fiscal challenges in advanced economies? Given that:
 - (i) Inflation would not reduce the real spending burden from pensions (usually CPI-indexed at least) and health care (obligations are in terms of services, rather than nominal amounts).
 - (ii) A substantial share of government debt in advanced economies is relatively short term and an increase in inflation would feed into higher borrowing costs? (See table from "Strategies for Fiscal Consolidation in the Post-Crisis World, Fiscal Affairs Department, 2010, which shows that an increase in inflation would reduce the debt/GDP ratio by a limited amount.)

Table 1. Counter-Factual Exercise: The Role of Inflation, 2009-14

	2009		2009–14	2014	
	Total Debt	MT-LT Debt 1/	Inflation, WEO 2/	Total debt, with average inflation equal to: WEO	6 Percent 3/
Australia	16.4	13.7	1.9	26.1	23.8
Canada	83.6	33.9	1.3	74.1	69.4
France	78.0	59.3	1.3	96.6	86.7
Germany	74.3	40.5	1.1	88.6	81.3
Italy	115.1	68.7	1.5	127.2	115.3
Japan	218.7	139.8	-0.6	247.6	225.0
Mexico	44.9	26.0	4.4	42.5	38.8
Turkey	46.8	26.0	4.8	46.6	43.4
UK	68.8	44.2	2.3	93.8	86.2
USA	83.8	45.7	1.6	103.1	94.6
Average	83.1	49.8	2.0	94.6	86.4

Sources: IMF, World Economic Outlook, January 2010, and IMF staff estimates.

1/ Medium-and-long-term debt in domestic currency, non-indexed.

2/ GDP deflator inflation, average over the period as projected in the WEO.

3/ This implies an increase in inflation by 4.2 percentage points over projected average inflation of 1.8 percent.

An impressive model/calibration exercise

How would an empiricist look at this?

How Would One Get Simple Empirical Validation of the Predictions in this Paper?

- Would not focus on US or other advanced economies today.
- The largest increase in debt during peacetime, but associated with weak demand. Hard to see high inflation in the next few years, though it may well happen before we are all retired.
- Rather, look at history of emerging and developing economies.
- Look for pick-up in actual or expected inflation? (Consensus forecasts, implied inflation from CPI-indexed bonds)
- Look at how debt maturity structure changes (e.g., emerging market crises; Olivier Jeanne's work on the share of long term, non-indexed, domestic currency debt)