After the disease, the debt

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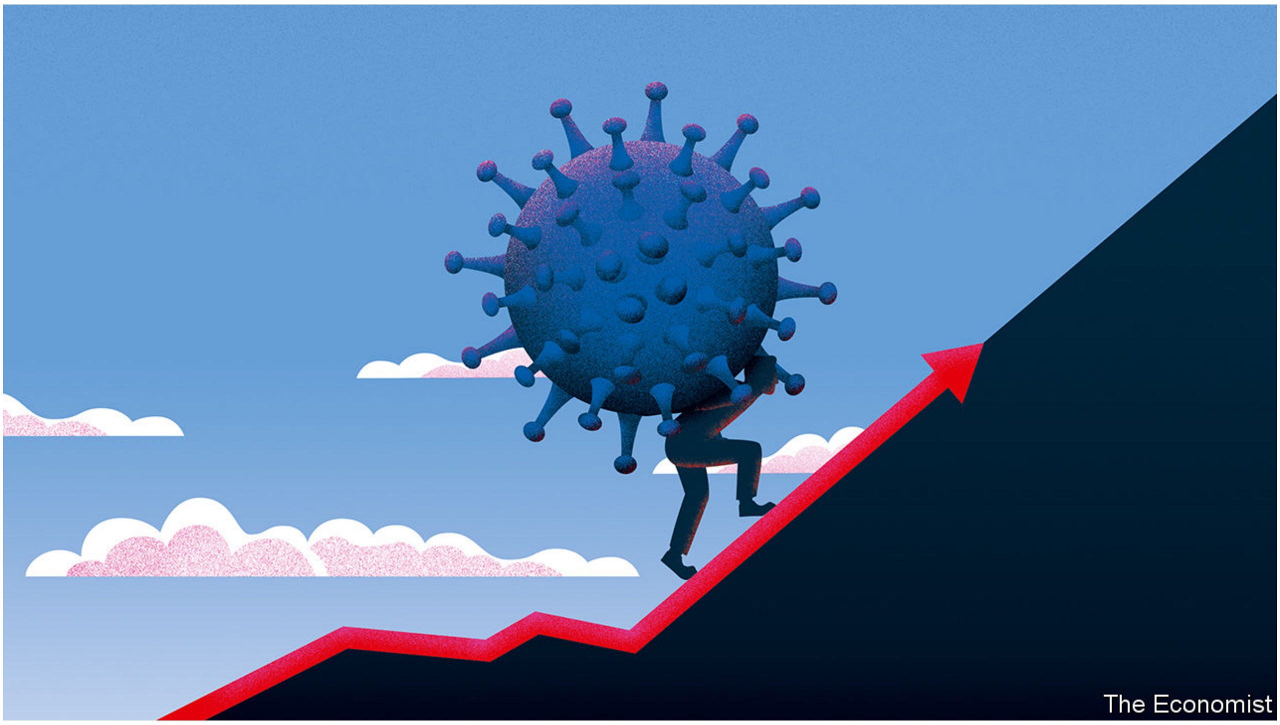

NATIONAL LEADERS like to talk about the struggle against covid-19 as a war. Mostly this is a figure of speech, but in one respect they are right. Public borrowing in the rich world is set to soar to levels last seen amid the rubble and smoke of 1945. As the economy falls into ruins, governments are writing millions of cheques to households and firms in order to help them survive lockdowns. At the same time, with factories, shops and offices shut, tax revenues are collapsing. Long after the covid-19 wards have emptied, countries will be living with the consequences.

An astonishing deterioration in the public finances is unfolding (see article). America's government is set to run a deficit of 15% of GDP this year—a figure that will go up if more stimulus is needed. Across the rich world, the IMF says gross government debt will rise by $6trn, to $66trn at the end of this year, or from 105% of GDP to 122%—a greater increase than was seen in any year during the global financial crisis. If the lockdowns last longer, the load will be greater. Managing such colossal debts will burden Western societies for decades to come.

Few subjects in economics attract more scaremongering than government borrowing. The national-debt clock ticking near Times Square in New York has warned of imminent fiscal Armageddon since 1989. In fact a country's public debt is not like a household's credit-card balance. When the national debt is owned by its citizens, a country in effect owes money to itself. Debt may be high, but what matters is the cost of servicing it and, as long as interest rates are low, this is still cheap. In 2019 America spent 1.8% of GDP on debt interest, less than it did 20 years ago. In 2019 Japan's gross public debt was already almost 240% of GDP, but there were few signs that it could not be sustained. In countries that print their own money, central banks can hold down interest rates by buying bonds, as they have in recent weeks on an unprecedented scale (the Federal Reserve has bought more Treasuries in five weeks than were issued, on net, in the year to March). Just now there is no risk of inflation, particularly since oil prices have collapsed. Most economists worry less that governments will borrow recklessly, than that they will be too timid because of an irrational fear of rising public debt. Inadequate fiscal support today risks pushing the economy into a spiral of decline.

Yet while spending freely now to avoid a deeper slump is the only sensible path, wild borrowing for years would eventually threaten trouble. America has strong defences against an outright debt crisis, because the dollar is the world's reserve currency and foreigners want to own its bonds. But other rich countries do not have that luxury. Italy's towering debt and membership of the euro zone condemn it to live with the perennial threat of a financial panic should the ECB stop buying its bonds.

The good news is that financial markets suggest rates will stay comfortingly low for decades. But so much is still unknown about the virus and its effects that, now of all times, investors cannot see clearly very far into the future. Some economists worry, that once the virus abates, a price-and-interest-rate spiral could get under way as a burst of demand runs up against supply chains that have been wrecked by the pandemic.

Governments will thus have to walk a treacherous path between stimulus today and prudence tomorrow. Success is not guaranteed. After the second world war countries shrank their debts over the course of decades, but only by using a bossy combination of high taxes on capital, financial repression (forcing domestic investors to hold debt at artificially low interest rates) and inflation, which erodes the real value of debts over time. A baby boom and rapidly rising levels of education made it easier for economies to grow their way out of debt. Japan has not faced a bond-market crisis since the 1990s, but its debt-to-GDP ratio has continued to rise. After the financial crisis in 2007-09 some European countries opted for budget cuts in order to cut debts, with mixed results and a big political backlash.

The politics of deficit reduction will be toxic. The pandemic will increase calls for lavish spending, not belt-tightening, especially on medical services. Ageing populations mean that there will be surging demand for pension and health spending in the 2030s and 2040s. It will get more expensive to maintain public services, let alone improve them. Politicians who trim benefits for pensioners will be punished by legions of elderly voters. There will be less spare cash to fight future crises, such as climate change or even another pandemic.

Faced with this daunting reality, rich-world governments will make a big mistake if they succumb to premature and excessive worries about budgets. While they are in the throes of the pandemic, the withdrawal of emergency support would be self-defeating.

Modestly higher inflation would help, by boosting the economy’s nominal growth rate. When this exceeds the interest rate, existing debts shrink relative to GDP over time. Unfortunately, central banks have recently undershot their inflation targets. Over the past ten years the cumulative shortfall in America and the euro zone has been about 5-6%. Central banks should pledge to make up the shortfall with catch-up inflation in the future. This would ease debt burdens without breaking past promises to hew to inflation targets.

And governments should prepare for the grim business of balancing budgets later in the decade. Done right, this would be fairer and more efficient than keeping rates low and letting inflation rip, which would transfer wealth in regressive and arbitrary ways, for example by reducing the debts of recklessly leveraged companies and homeowners. Better to raise taxes on land, inheritance, carbon emissions and, in America, consumption—and at least try to trim spending on the elderly.

National-debt service

Perhaps interest rates really will stay low while growth rebounds and inflation rises just slightly, easing the burden of debt. More likely is that living with high debts will be a nerve-racking and gruelling slog. Making budgets add up looks as if it will be a defining challenge of the post-covid world—one that today’s politicians have not yet even started to confront.■