

Tempted by inflation? Remember the 1970s

Using high inflation for debt reduction would carry major costs and risks, which reduce the likelihood of policy makers reverting to this solution. High inflation gives rise to distortions in resource allocation, reduces economic growth, hurts the poor, creates social and political instability, is not easily contained when unleashed and leads to substantial output costs that need to be brought down again. Governments are also pushed into shorter maturities, rolling over their debt more often, and borrowing costs go up for many years to come. These are the key lessons of the 1970s for the advanced economies. Nevertheless, a moderate rise in inflation could be part of the policy response to the fiscal crisis.

There are worse things than inflation ...

Aggressive government response to the credit crisis has resulted in the largest worsening of fiscal accounts since World War II. At best, higher debts and deficits will push interest rates up, weakening growth prospects in advanced economies. At worst, the weaker fiscal outlook will lead to concerns that debt will be “inflated away” or that default is inevitable. Such concerns would lead to higher yields and make it difficult for governments to borrow over the long term, potentially leading to refinancing crises. A fiscal crisis would be at least as severe as a crisis in the private sector, because the government couldn’t bail itself out.

Over the last couple of months a number of academics and policy-makers have proposed increasing inflation targets from 2% to 4% in order to give monetary policy more scope to fight future economic slumps. This has come at a time when markets are already concerned that inflation could be part of the policy mix for solving the fiscal crisis. An unexpected rise in inflation would reduce the real value of government debt, because medium-

and long-term domestic currency debt accounts for three-quarters of advanced economy borrowing. However, long-term interest rates would probably rise with inflation and any maturing debt would have to be refinanced at higher rates. To illustrate these effects, the table below shows forecasted 2014 debt ratios for a sample of countries if average inflation from 2009-14 turned out to be 6%, as opposed to just under 2%. The effect would be to reduce the debt ratio in the sample by eight percentage points to 86.5%. This is less than a quarter of the predicted rise in the debt-to-GDP ratio at prevailing inflation rates.

Debt-to-GDP (%) - different inflation scenarios			
		2014	
	2009	Low inflation	High inflation
Australia	16	26	24
Canada	84	74	69
France	78	97	87
Germany	74	89	81
Italy	115	127	115
Japan	219	248	225
Mexico	45	43	39
Turkey	47	47	43
UK	69	94	86
USA	84	103	95
Average	83	95	86

Low inflation: assuming inflation averages 1.7%
 High inflation: assuming inflation averages 6%

Source: Coutts, IMF

...but inflation can only go so far

Higher inflation offers only a partial solution to the current fiscal problems of the advanced economies. Higher borrowing costs partially offset the positive impact of rising inflation in bringing down debt ratios. If inflation alone is to be used as a covert way of defaulting on debt, very high rates of inflation would be required. Indeed, history shows that debt crisis often go hand in hand with inflation rates of above 20%.

Carl Astorri
 + 44 20 7753 1612
 firstname.lastname@coutts.com

Jean-Maurice Ladure
 + 44 20 7753 1469

Henry Lancaster
 + 44 20 7957 2426

Georgios Tsapouris
 +44 20 7753 1888

Issued by Coutts & Co, which is authorised and regulated by the Financial Services Authority. Coutts & Co is registered in England No. 36695. Registered office: 440 Strand, London WC2R 0QS.

The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance should not be taken as a guide to future performance. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down.

The information in this document is not intended as an offer or solicitation to buy or sell securities or any other investment or banking product, nor does it constitute a personal recommendation. The information is believed to be correct but cannot be guaranteed. Any opinion or forecast constitutes our judgement as at the date of issue and is subject to change without notice. Any Coutts company, or a connected company, its clients and officers may have a position or engage in transactions in any of the securities mentioned.

The analysis contained in this document has been procured, and may have been acted upon, by Coutts & Co and connected companies for their own purposes, and the results are being made available to you on this understanding. To the extent permitted by law and without being inconsistent with any applicable regulation, neither Coutts & Co nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such analysis.

Not all products and services offered by the individual Coutts companies are available in all jurisdictions, and some products and services may be available only through particular Coutts companies.

None of the overseas Coutts companies or offices is an Authorised Person subject to the rules and regulations made under the Financial Services and Markets Act 2000 for the protection of investors and depositors, and compensation under the Financial Services Compensation Scheme will not be available in respect of business transacted with them.