WHY THINGS COULD GET REALLY BAD

High inflation is a distant memory. So distant, in fact, that people forget that inflation can occasionally—and despite the best efforts of the Fed—take quantum jumps. In 1978, for example, inflation was 7.6%; two years later it was 13.5%. And all the while the Fed was frantically trying to keep things under control with monetary policy, to no avail.

The Federal Reserve simply does not have short-run control over inflation, a fact that Alan Greenspan isn’t eager to share. Indeed, Greenspan’s remarkable record in persuading workers and firms to gear their wage and price hikes to low inflation is a testament to his gravitas. That’s why Senator John McCain said a few years back that when Greenspan expires, someone ought to “prop him up and put a pair of dark glasses on him and keep him as long as we could.”

But it’s one thing to convince markets that inflation will stay low when you’re running surpluses and everyone believes your fiscal house is in order, and another when you’re reporting $500 billion deficits, dramatically raising federal spending, cutting taxes like mad, and facing a tidal wave of bills associated with baby-boomer retirement. Countries that can’t cover their spending with taxes or via further borrowing are forced to do so by either printing cash or creating money electronically. And more money chasing the same goods ultimately means higher prices.

Like other governments, ours engages in a sleight of hand when it makes money by making money. In creating money to cover expenditures, Uncle Sam has the Treasury sell bonds for the needed amount to the public, and then the Fed buys the bonds right back with either fresh cash or an electronic bank credit. The result is the same as if the Fed simply gave the Treasury the money directly.

If a country’s fiscal gap—the difference between its planned future spending (including debt service) and its projected future taxes—is massive, the government will eventually have to really crank up the manual and electronic printing presses to cover the difference. At that point, something extremely scary can happen: hyperinflation.

Printing money to pay unaffordable bills dates at least to Emperor Diocletian, who ran what may be the nastiest case of hyperinflation in world history. In the last century two dozen countries hyperinflated, the most famous (although hardly the worst) example being Germany during the 1920s. Reducing real spending this way is ugly, but it works, provided nominal spending isn’t indexed to price levels. In the U.S., over the past 20 years most federal expenditures have been indexed. Hence, using inflation here to cut real spending requires outpacing indexation, which accelerates price increases even more.

But can’t the Fed always raise interest rates a lot to keep inflation in check? Nope. When the Fed is faced with a choice of (a) defaulting on federal government debt and failing to pay critical bills like Medicare and Social Security or (b) printing money, it has to go with (b). And by so doing, it creates a nightmare scenario: Interest rates, out of the Fed’s control, now reflect the prevailing inflation rate, which in turn is determined by the rate of new-money creation, which is itself on autopilot. The reason interest rates reflect inflation is that lenders need to be compensated for implicit default (i.e., paying creditors in watered-down dollars).

Hyperinflation is a real and present danger for the simple reason that the U.S. government is effectively bankrupt. Its fiscal gap is $51 trillion, when measured as a present value. That’s 11.6 times official debt, 4.5 times GDP, and 1.2 times private net wealth. Coming up with $51 trillion without a printing press would require, immediately and permanently, either hiking federal income taxes 78%, cutting Social Security and Medicare benefits 51%, or eliminating more than 100% of federal discretionary spending, which ain’t easy. And waiting only makes matters worse.

That is America’s menu of pain. When investors around the world wake up to U.S. insolvency, it will be extremely expensive for our government to borrow. The only option then will be printing huge sums of money—generating exactly the hyperinflation the bond market has decided to expect.

The one way to avoid code red is immediate and very painful entitlement reform—precisely the thing leaders in Washington don’t want to talk about. Economics isn’t called the dismal science for nothing.

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THE ECONOMY