



## A Top Economist's Nightmare Scenario

By Charlie Curnow

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Remember the 1970s? Stagflation like we saw then could return to the U.S. if unsustainable public debt levels trigger a selloff of government bonds and dollar-denominated holdings, according to a recent [study](#) by John C. Cochrane. Cochrane, a finance professor at the University of Chicago's Booth School of Business, is president of the American Finance Association and is perhaps best known for his response to Paul Krugman's article in the *New York Times* on why mainstream economics failed to anticipate the financial crisis.

Currently, U.S. central bankers worry more about deflation than inflation. At its September policy meeting, for example, the Federal Open Market Committee stated that underlying inflation measures are still below the rates associated with maximum long-run employment and price stability. The committee also declared its belief that continued slack in resource utilization means inflation will remain "subdued for some time" before reaching target levels.

The current U.S. inflation rate is 1.1 percent, according to the latest consumer price index report – quite low. The core index less food and energy is even lower, at 0.8 percent.

Meanwhile, Keynesian economists like Paul Krugman are encouraging bigger fiscal deficits, arguing that the slow inflation of the past two years supports the idea that the government's fiscal stimuli haven't been large enough. The U.S. economy grew at an anemic 1.7-percent pace in the second quarter of 2010, compared to the 2.5 percent most economists say is normal. During this slow growth, Krugman and others note, total government payrolls have actually shrunk. Data show that 350,000 jobs have been lost across all levels of government since President Obama took office in January 2009, as state and local cuts have dwarfed a small increase in federal employment. Government purchases of goods and services rose just 3 percent per year over the past two years – an even slower pace than before the recession. It isn't that economic stimulus hasn't worked, Keynesians say, it's that it hasn't been tried.

Cochrane replies that Keynesians underestimate the risk of sovereign default, not to mention the inflation it could cause. Echoing the arguments of austerity-minded policymakers on both sides of the Atlantic, Cochrane writes that, even though the current situation is bad, a default on U.S. federal debt – or even a threat of one serious enough to set off a panic in the Treasury bond market – would be a "nightmare." Countries such as Greece, Portugal and Spain have already demonstrated that the threat of sovereign default is real, as are the consequences in the bond market for countries that fail to control their debts. If our economic growth rates continue to lag, the U.S. could be next.



## **“The nightmare scenario”**

The cataclysmic chain of events Cochrane calls "the nightmare scenario for inflation" begins with economic growth that stagnates long-term, possibly reinforced by high tax rates, market inefficiencies caused by government interventions, and policy uncertainty. Cochrane detailed this scenario in a paper published this month by Booth's Center for Research in Security Prices.

Long-term economic stagnation could escalate the government's debt problems to a full-blown crisis. Eventually, the U.S. federal government will need to make good on its mounting financial promises. It may also need to engage in further bailouts of sovereign countries such as Greece, indebted states and municipalities, and private holdings such as pension funds and mortgages. Barring substantial budgetary reforms, the rising costs of entitlement programs such as Social Security and Medicare may also contribute to unsustainable debt levels as the U.S. population ages.

When investors see exploding federal debt levels coming, they may rush to abandon their government and dollar-denominated debts, Cochrane wrote. Investor demand for higher risk premiums on U.S. Treasury bonds and other government securities could lead to higher effective interest rates, and further drag down demand for American debt, and stifle the market for dollars. Stagflation could follow.

Investors have taken interest rates into their own hands before. Between October 1993 and November 1994, so-called "bond vigilantes," acting on fear of loose spending policies under the Clinton administration, participated in a massive selloff of U.S. Treasury bonds that pushed yields on 10-year securities from 5.2 percent to more than 8 percent. The rising interest rates in 1994 prompted the administration to scale back its economic stimulus plan. Many economists say that a similar phenomenon may currently be unfolding in Greece, where bond yields have remained high since the government's securities were downgraded to "junk" status in April, and the threat of a sovereign default still looms despite help from the European Union and the International Monetary Fund.

America's last significant bout with stagflation occurred during the 1970s and 80s. In 1975, U.S. unemployment climbed to 8.48 percent, while inflation rose to 9.2 percent, bringing the so-called Misery Index, the sum of the unemployment and inflation rates, to 17.68, a historical high since the federal government started tracking unemployment and inflation statistics in 1948. The all-time high of 20.76 came in 1980, when an unemployment rate of 7.18 percent and an inflation rate of 13.58 percent ushered Jimmy Carter out of office. Rather than sovereign default risks, however, economists blamed the demise of the gold standard in 1971 for the economic malaise of that period, as well as cost-push factors such as the 1973 oil crisis and wage-price controls instituted under the Nixon administration.



## **A bad dream come true?**

So will Cochrane's nightmare scenario come true? It depends largely on whether will investors retain their belief in the ability of the U.S. government to pay off its debts. The good news is that U.S. Treasury still retains its perfect AAA bond rating, even as the governments of countries such as Greece, Spain and Portugal have been downgraded, in Greece's case to "junk" status. Yields on long-term Treasury bonds have been small over the past two years, suggesting low expected inflation. Indeed, instead of fleeing from government securities since the onset of the European sovereign debt crisis earlier this year, investors have actually flooded the U.S. bond market in search of income.

Furthermore, while America's public debt stands at a sizeable 53 percent of gross domestic product, according to 2009 estimates, it remains only the 47<sup>th</sup>-most indebted nation in the world relative to its GDP. Japan's debt-to-GDP ratio, for example, dwarfs that of the U.S. at 189 percent, as do those of Italy (115 percent) and Greece (113 percent). If the U.S. federal government is to default, it is therefore very likely that we will see it coming; other dominos will fall first. For now, at least, Cochrane's stagflation scenario seems to be no more than a bad dream after all.

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