Project Syndicate

Say More

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This week in Say More, PS talks with economist John H. Cochrane, a senior fellow of the Hoover Institution and an adjunct scholar at the CATO Institute.

Project Syndicate: A year ago, you argued that surging inflation was forcing policymakers and commentators to abandon "wishful thinking." Today, the inflation picture has become somewhat murky in the United States, and hopeful predictions from earlier this year – when price growth was slowing, and GDP and employment growth were holding on – are giving way to more cautious assessments. Are sanguine projections just more wishful thinking? How do you read the inflation signals of recent weeks?

John H. Cochrane: I try hard not to read weekly signals! Economics is really not about short-term forecasting or peering at the latest numbers. Economists are better at conducting "if-then" analysis and discerning longer-lasting forces. And on those fronts, it's worth being explicit about how one views the world. My view, of course, is shaped by fiscal theory. In that view, we are largely inflating away the dramatic deficits of 2021-22. As we have seen, fiscal inflation comes without any change in interest rates, and, as we seem to see, it moderates without interest rates larger than inflation. But fiscal theory warns that we could be headed for a period of stubborn inflation, owing to higher interest rates and still-mounting deficits, for which there is no repayment plan. Other theoretical views come to different answers.

PS: "While interest-rate policies get headlines," you wrote early last year, "the Fed is now most consequential as a financial regulator." And in that capacity, it made serious mistakes after 2008 – mistakes on which it has been doubling down lately. The result is a financial system "oriented around dangerously misaligned incentives." How much responsibility should the Fed bear for recent bank failures, and what would it take to "reverse the basic premise of a financial system in which the government always guarantees mountains of debt in bad times"?

JHC: The recent bank run triggered by the failure of Silicon Valley Bank proved that the regulatory framework is fundamentally broken. To my mind, the Treasury-market rescue, money-market-fund bailout, and corporate-bond-price guarantee of 2020 proved the same thing, but not everyone seems to have noticed those.

The events were simple. Silicon Valley Bank took uninsured deposits and bought long-term bonds. When interest rates rose and bond prices fell, the bonds were worth less than the deposits, and depositors ran. Yet thousands of regulators, enforcing tens of thousands of pages of regulation, failed to spot this elephant in the room.

The basic idea that government guarantees deposits and other debts, while trying to regulate away the consequent incentive to take risks, is hopeless. Another ten thousand pages of regulation will not change that. Casting blame is not productive. The people are good and smart, but they are stuck in a dysfunctional Byzantine system.

I've written a lot about the alternative, which I call narrow deposit-taking with equity and long-term-debt financing for banks. We can end private-sector financial crises forever, with essentially no regulation. A crisis is not the time to address moral hazard. But this time, please, let us do it after the crisis passes. (By the way, this issue is unrelated to fiscal theory. So you can still like fiscal theory, even if you think my views on banking are unhinged.)

PS: "Generally speaking," you wrote in 2021, "inflation can be stabilized with little recession if people believe the necessary policy tightening will be seen through." In your new book, The Fiscal Theory of the Price Level, you underscore how beliefs about fiscal policy affect prices, explaining that fiscal theory predicts inflation "when debt is larger than what people think the government will repay." You also say that the US "easily" has the means to repay its debts if it "chooses to do so." So, what causes people to decide that debt owed by the US exceeds what the government will repay?

JHC: Fiscal theory is essentially about the value of government debt. It views that value in the same way we view the value of stocks and bonds. Just as a stock or bond price equals the present value of dividends or coupons, the real value of government debt, which declines with inflation, is equal to the present value of fiscal surpluses. A loss of faith in fiscal sobriety leads to inflation, just as a loss of faith in dividends or earnings leads to stock-market declines or bank runs. So, to your question, what causes people to decide that a company's dividends will be lower in the future? Well, it's hard to say. That difficulty does not undermine the price-equals-present-value paradigm; it just says that an economist's life is not easy.

For the government, there are many laws, institutions, reputations, and norms – "regimes" to economists – that strengthen people's belief that the government will, sooner or later, repay its debts. Joe and Jane do not sit down and forecast future deficits in order to decide how much they are willing pay for a cup of coffee. But their general faith in the government – or lack thereof – does influence how they decide to spend or save their dollars and government-debt holdings, which is fundamentally what drives inflation.

We have seen cases where the restoration of faith in the overall system has stopped inflation in its tracks, even with no immediate change in budgets. And there have been moments when people have lost faith and inflation has erupted despite little current news, seemingly out of nowhere.

Statements and commitments by politicians do matter, at least a bit. I think it is significant that in 2008, the US administration quite clearly said that there would be stimulus now, but debt repayment later, whereas in 2020-21, there was no mention of repayment. Congress suspended budget rules requiring that new spending be offset even by promises of taxes or future cuts.

There is also a bit of run mechanism to fiscal inflation. I dump my Treasury debt and try to buy real assets when I sense that everyone else might do so tomorrow.

It would be awfully nice if I could point to a well-measured government statistic – "expectations of discounted future surpluses" – just as it would be nice if there were such a statistic to tell us what the "right" stock price is. There isn't. That doesn't make the theory wrong; it doesn't mean price isn't the present value of dividends. To make life harder, lots of inflation and disinflation comes from changes in interest rates and interest costs – or "discount rates" in asset-pricing parlance – the sources of which are even tougher to pin down.

BY THE WAY . . .

PS: America's situation contrasts sharply with, say, Greece's, which you cite in The Fiscal Theory of the Price Level*: since the country uses euros, and agrees to pay its debts in euros, it must either run surpluses to pay its debts, or else default on them. How does the denomination of a country's debt affect the application of fiscal theory, and what does this mean for the European Central Bank as it attempts to address eurozone inflation?*

JHC: Greece is an interesting cautionary tale, in that its debt looked fine until it suddenly didn't. The same mechanics can occur in the US, causing a spike in inflation instead of a default.

Yes, a country that borrows in or uses foreign currency can't inflate away its debt. Its debt is like corporate debt – repay, default, or get someone to bail you out – whereas debt in one's own currency is like corporate equity, with bad news met by a decline in value. As in corporate finance, there are tradeoffs. Foreign-currency, common-currency, or indexed debt, like corporate debt, commits the government to repay or face large costs. But when the bad time comes, the large costs of default kick in. Tying yourself to the mast is painful if the ship starts to sink and you have to free yourself. Own-currency debt, like equity, makes it easier to devalue debt, but that raises the temptation to devalue too often.

The euro as a whole follows fiscal theory, however, with the added problem that 20 countries are issuing debt, so each one feels only a fraction of the inflationary costs of its actions. It is increasingly clear that the ECB will ensure that countries do not default, even if that means monetizing debts. This fundamental problem hasn't been solved yet, and the ECB is facing it hard right now.

PS: At first glance, fiscal theory might seem to complicate the principle of central-bank independence, not least because of the role politics plays in fiscal decision-making. In your book, however, you explain that an "independent central bank is a fiscal commitment." What, then, would characterize an optimal relationship between monetary and fiscal policymakers in the fight against inflation?

JHC: Yes, even in fiscal theory, at the end of the day, a central bank can stop inflation by refusing to print money to repay debt. And its balance sheet can communicate that there are assets backing the currency. Also, the ability to set interest rates makes central banks powerful, even in pure fiscal theory with no financial frictions. Add financial frictions, and they are more powerful still.

I'll demur on "optimal" for these short answers. I write about a lot of arrangements: introducing new fiscal rules (automatically increase surpluses with inflation), attaching inflation commitments to debt repayment, targeting the index-bond spread rather than the interest-rate level, implementing separate central-bank balance sheets, including indexed debt as central-bank assets, restructuring US debt (indexed vs. nominal), and so on. I'm still thinking through how each of those works, before proclaiming one "optimal," and thinking through how decisions are made when we separate one government into two actors. And to declare something "optimal" requires one to take a stand on what the costs of inflation are. A perpetual problem is that we all sort of know inflation is damaging, but it's a lot less painful in our models. But a lot of work has already been done on these issues, which can be imported into fiscal theory very quickly. We've just scratched the surface on fiscal theory!

PS: You lament in your book's preface that "economists too often give a clever name to a puzzle, proclaim that no standard economic model can explain it, and invent a new theory." But "if you work a little harder, a simple supply and demand story explains many puzzles." At a time when calls for reforming economics are growing louder, are there orthodoxies that you agree need rethinking? Which should be left alone?

JHC: I do take pleasure in the style of work that, with a little extra effort, puts a puzzle into a simple supply-and-demand framework, or extends classical economics, rather than proclaiming a new theory for each new puzzle. I think of that as classic Chicago-style economics, and look how productive it has been.

I also note that each issue of each major journal contains about nine new theories, of which 8.9 are swiftly forgotten. But that's an esthetic question. Some new theories do emerge and gain traction, and they are justly famous when they do work out.

I don't like to be prescriptive, and the habit of calling for action – "reforming economics," "orthodoxies….need rethinking" – without clear subjects makes me uncomfortable. Who is going to do this reforming? (That's not criticism; the question echoes common sentiments well.) There is a lot going on in contemporary economics that I think is immensely valuable and productive, and a lot going on that I think will end up as once-trendy dead-ends. But that's true in science as well. It's best simply to allocate one's efforts to what one thinks will be productive, rather than criticize. And critiques should be detailed and scholarly; this isn't the place for that.

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