

Why the U.S. Can't Inflate Its Way Out of Debt

By [Morgan Housel](#)

April 16, 2010 | [Comments \(100\)](#)

This country is in piles of debt. Projections for how much more we could load on in the coming decades are downright nightmarish. You think it's bad now? [Just wait.](#)

It's obvious that big changes are in store, but progress (or even the hope of it) is painfully absent. Eventually, Stein's law -- if something can't go on forever, it won't -- will prevail, and we'll be forced to fix the problem.

How we'll do so is the trillion-dollar question. There are only three ways to end runaway deficits: cut spending, raise taxes, or allow deliberate inflation.

The easy way out

The third option is often cited as the "tried and true" method, and not in a good way. Indebted countries habitually ask their reserve banks to run the printing presses at full bore. Governments can then pay their bills with the newly printed money, at the cost of inflation. This eliminates debt without forcing politicians to make unpopular decisions on spending and taxation, which is why it's so prevalent.

But the idea also has a growing chorus of nonpolitical supporters. As an MSN Money article published on Wednesday titled, "[Why Inflation Would Be Good For Us](#)," declares:

... a quick bout of higher-than-normal inflation would lower the nation's debt in real dollars, bailing the government out of the debt threat. That means we could avoid Draconian tax increases or big spending cuts, both of which would be politically unpopular and could scuttle the economic recovery.

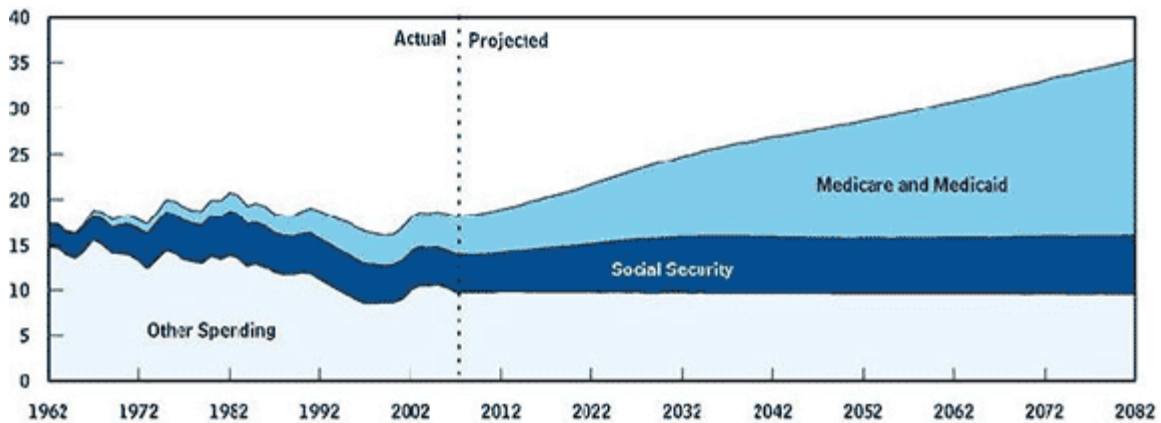
Sounds neat! Too bad it's fantasy thinking.

The timing of this article was unfortunate. Just 18 hours after it was published, Fed chairman Ben Bernanke sat before the Joint Economic Committee, which asked him point blank about inflating away debt. His answer gets to the heart of the matter: "Given the structure of our debt, [inflation] wouldn't even help reduce the debt ... given that so many of our obligations are indexed."

Bingo. Inflating away debt only works when the obligations are in fixed dollar amounts, like a mortgage. But essentially, all of our long-term fiscal problems are entitlement commitments that grow (are "indexed") with inflation. When inflation rises, spending on Social Security and Medicare rise at the same rate. So the debt-inflation relationship is the opposite of the get-out-of-jail-free card some envision. Debt still goes up in real dollar terms, creating even more of a death spiral.

Problems that won't go away

And I really do mean that "essentially all" of our problems are entitlement commitments. This chart, from the Congressional Budget Office's (CBO) 2008 Budget and Economic Outlook, tells the story (the y-axis is spending as a percentage of GDP):



These projections are more than two years old, and they've undoubtedly grown uglier since. In a more recent report, the CBO notes, "Almost all of the projected growth in federal spending other than interest payments on the debt comes from growth in spending on the three largest entitlement programs -- Medicare, Medicaid, and Social Security."

And all three of these programs grow with (or cause) inflation. Inflation in medical costs, in fact, has historically been one of the big drivers of overall inflation. That largely explains Medicare's surging burden, not to mention why premiums at

much-maligned megainsurers **WellPoint** (NYSE: [WLP](#)) and **Cigna** (NYSE: [CI](#)) have plowed skyward. For Social Security, inflation measured by the [consumer price index](#) (where medical costs are also a component) fuels so-called cost-of-living adjustments, which push entitled benefits higher. When Ida May Fuller received the first Social Security check in 1940, she got \$22.54. Today, the average disbursement is \$1,066.60. Ponder why this inflation has yet to solve our debt problems, and you'll see how faulty the inflate-ourselves-to-freedom argument is.

What now?

If inflation isn't the answer, then cutting spending and raising taxes are. But doing this scares the everliving mess out of politicians, because it rankles the people who vote for them. Even those who talk tough about spending cuts ultimately cave. A good example came in January, when President Obama proposed creating a deficit reduction committee. The Senate immediately voted 97-0 (a rare show of unanimity) that the commission would be banned from touching Social Security benefits. We've become a morbidly obese country on a mission to outlaw diet and exercise. Good luck with that.

Overhauling entitlement spending is the [way out](#) of our long-term debt mess. I just wonder how feasible that is, especially in a proactive way. For now, we'll just wait for Stein's law to kick in.

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