Written by **Bob Adelmann** on January 17, 2014

# Harvard Professors Predict High Inflation, Defaults for U.S.


Two Harvard professors are predicting that America will soon be forced to adopt financial measures only previously used by third-world countries in order to control its runaway debt. Economists Carmen Reinhart and Kenneth Rogoff gained international attention and applause with their 2009 book, *This Time is Different: Eight Centuries of Financial Folly*, followed by the publication in 2010 of *Growth in a Time of Debt*.

The first gained international recognition for its analysis of fiscal follies implemented by governments to rein in out-of-control debts and pointing to the similarities to the current environment in the United States. The second book gained the professors notoriety for claiming that too much debt predictably slowed economic growth, especially when government debt exceeded 90 percent of a country's gross domestic economic output. Keynesians seeing the implications that would come from implementing austerity measures to slow the growth of that government debt discovered some mathematical errors in the book's thesis, and the media then directed all their attention to those flaws instead of focusing on the message: Too much debt slows economic growth.

This time the media have been remarkably reticent to focus on the professors' predictions. The current study entitled "Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten" was initially prepared for an International Monetary Fund (IMF) conference back in September 2012 and was only made available by the IMF for public consumption this past December. When it was published, the frontispiece was laden with disclaimers: "The views expressed … are those of the authors and do not necessarily represent those of the IMF or IMF policy." And, "[Such] working papers describe research in progress by the authors and are published to elicit comments and to further debate."

It took a month for a few obscure writers to wade through the paper and come up with cogent summaries of what the professors are predicting. John Morgan at *MoneyNews* said the paper "explained the developing world is fooling themselves by maintaining they are different from poorer nations and can resolve their debt overhangs with austerity, growth and economic maneuvering."

Better known commentator Ambrose Evans-Pritchard, writing for the British tabloid *The Telegraph*, was only slightly more accurate than Morgan:

> The paper said policy elites in the West are still clinging to the illusion that rich countries are different from poorer regions and can therefore chip away at their debts with a blend of austerity cuts, growth and tinkering ("forbearance")….
>
> The paper says the Western debt burden is now so big that rich states need the same tonic of debt haircuts, higher inflation and financial repression — defined as an "opaque tax on savers" — as used in countless IMF rescues for emerging markets.

The theme of the paper is straightforward and likely to enrage those elites who are accused by the authors of suffering from "collective amnesia" about recent defaults by developed countries in the past, which included theft (direct and indirect) from savers, inflation to reduce the purchasing power of the currency, capital controls that keep capital owners from being able to escape the theft, and the forced purchase of government bonds by pension plans, retirement accounts, and insurance companies.

Without saying as much, the professors note indirectly that when governments look for ways out of their excessively large "debt overhang" they go to where the money is. When John Rutledge, the owner of Rutledge Capital, was asked where the money is, Rutledge did some digging and concluded that the total assets of the citizens of the United States totals more than $200 trillion, and even he admitted that he left out an awful lot that was hard to track down: "All we have to know is that these [missing] things would add up to a very big number … far in excess of $200 trillion."

Short of direct confiscation of some of those assets (e.g., Cyprus banking thefts) to help the government balance its books, the professors explored other more indirect measures employed by governments in third world countries and other developed countries in recent history.

First, they discard out of hand any notion that the country's economy will ever be strong enough to grow its way out of the enormous debt overhang (which the authors show to be more than 270 percent of America's economic output) and that other measures will soon have to be employed. One way, say the authors, is to

> stuff [government] debt into local pension funds and insurance companies, forcing them through regulation to accept far lower rates of return than they otherwise might demand.

By forcing those pension plans and insurance companies to buy up government debt, the government will have neatly created another market for that debt and not have to rely so completely on the Federal Reserve to fund its ongoing deficits. Savers will be punished with lower rates of return, and capital creation will be slowed as a result.

Further, say the authors, "Domestic debt can also be reduced through inflation," as if such inflation has not already been going on for decades. When President Roosevelt confiscated gold from the American people in 1933, the first thing he did was devalue the paper currency that remained by some 40 percent. Since then the Fed has continued such depreciation and devaluation to the point where, today, it takes nearly $1,800 to equal the purchasing power of $100 back then. Put another way, the American people have already suffered a loss of 94 percent of their purchasing power through inflation since 1933. Such inflation of the currency supply is a strategy often used by third world countries (i.e., Zimbabwe) to fund their government's deficits.

Even with these tools (repression and inflation), the federal government will have to go further. It will have to "restructure" its debt "far beyond anything discussed in public." The authors do not leave the reader hanging with just how horrendous such debt "restructurings" will be. Just look at what happened following the First World War:

> Of the 17 countries listed … as having borrowed from the United States during or right after the war, only Finland repaid its debt. The remaining countries received what in today's language is now called debt forgiveness of the type usually associated only with highly indebted poor countries.

The impact on the United States, the creditor nation, was gigantic: The total defaults by its debtors amounted to an astonishing 15 percent of the country's gross domestic product. And just when were these defaults allowed? Right at the bottom of the Great Depression, in 1934. Noted the authors, "As unpleasant as these credit events were, it is clear that they played a substantive role in reducing the debt overhang from both World War I and the Great Depression."

And then the authors added, “It is difficult to envision a resolution to the current five-year-old crisis that does not involve [even] a greater role for explicit restructuring.”

If more evidence were needed to show America’s economic decline toward the level of “developing” countries, as noted by the latest release of the Heritage Foundation’s Index of Economic Freedom earlier this week, the Harvard professors have provided it.

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