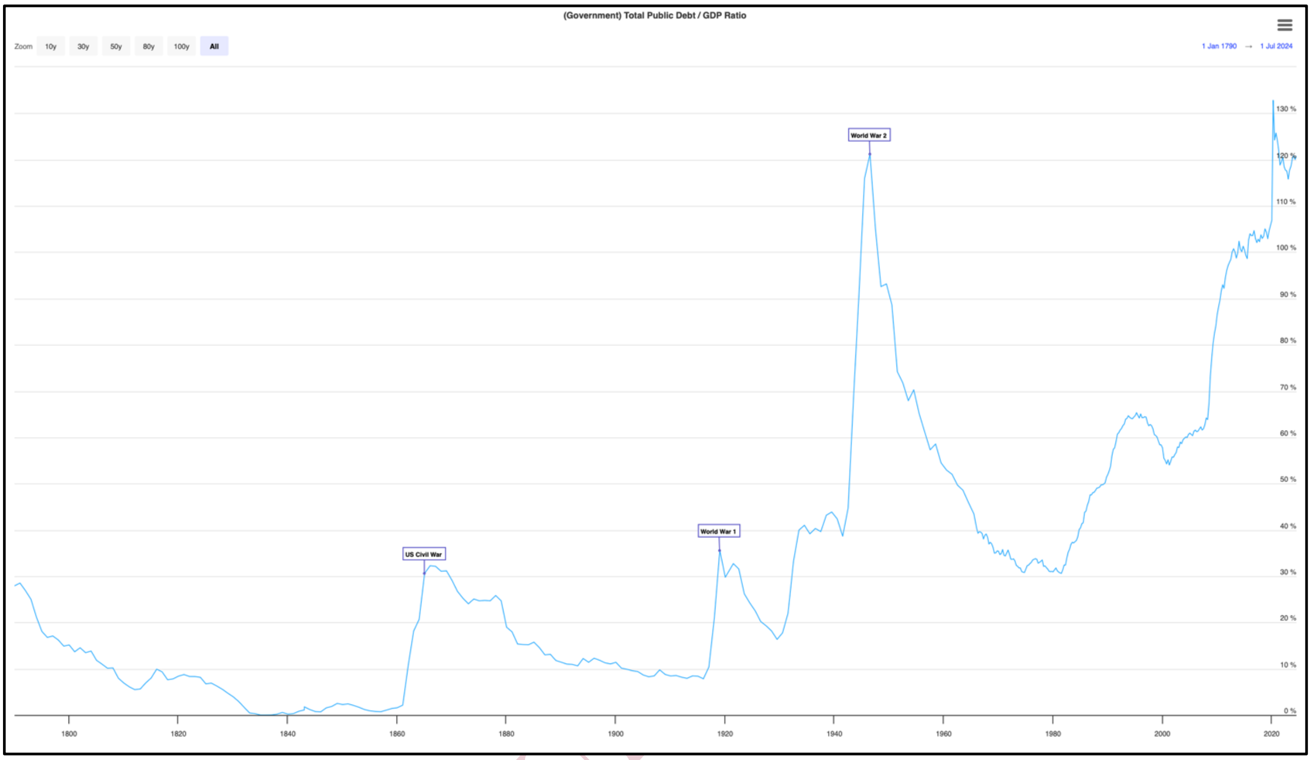
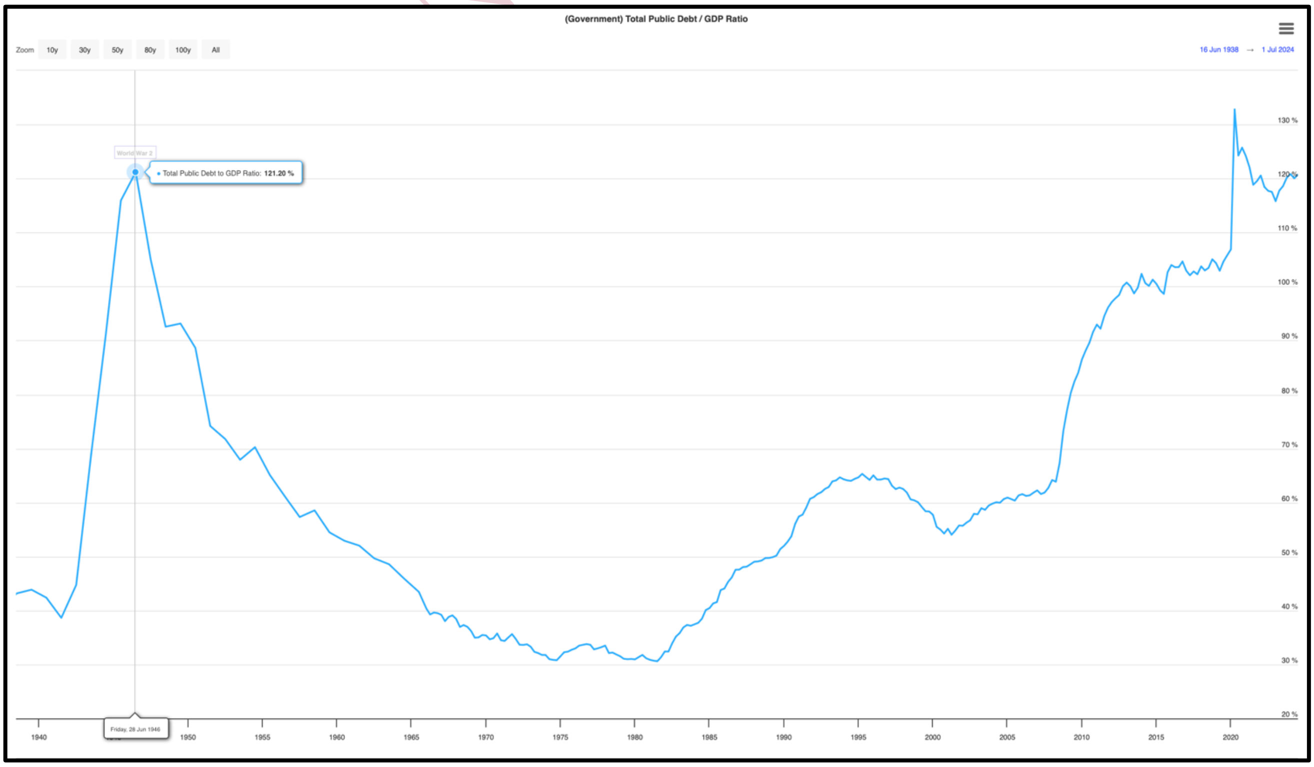
19th September 2022

How the US will inflate its debt?

US Debt to GDP has hit an all-time high. There are media headlines suggesting that the US will default on its debt. But not many know that the US has had a debt to GDP as high as the current one and successfully deleveraged its balance sheet by inflating away its debt. Infact many countries have done this in the past. Following graph shows the history of US debt/GDP since independence. The US has deleveraged thrice so far- post civil war, post-World War 1 and post-World War 2. It is safe to say that the US will try to do the same rather than "defaulting" in the true sense.



If I zoom in on the period post-World War 2, the chart looks as follows. The US was deleveraging from 1946 to 1982- having reduced its debt to GDP from about 125% to 30%.



During this same period, the US government kept increasing its rate from 1945 to 1982, reaching the maximum of 16% at a point of time. Then again, post 1982, the government deleveraged for the next 40 years, with the end of Covid.

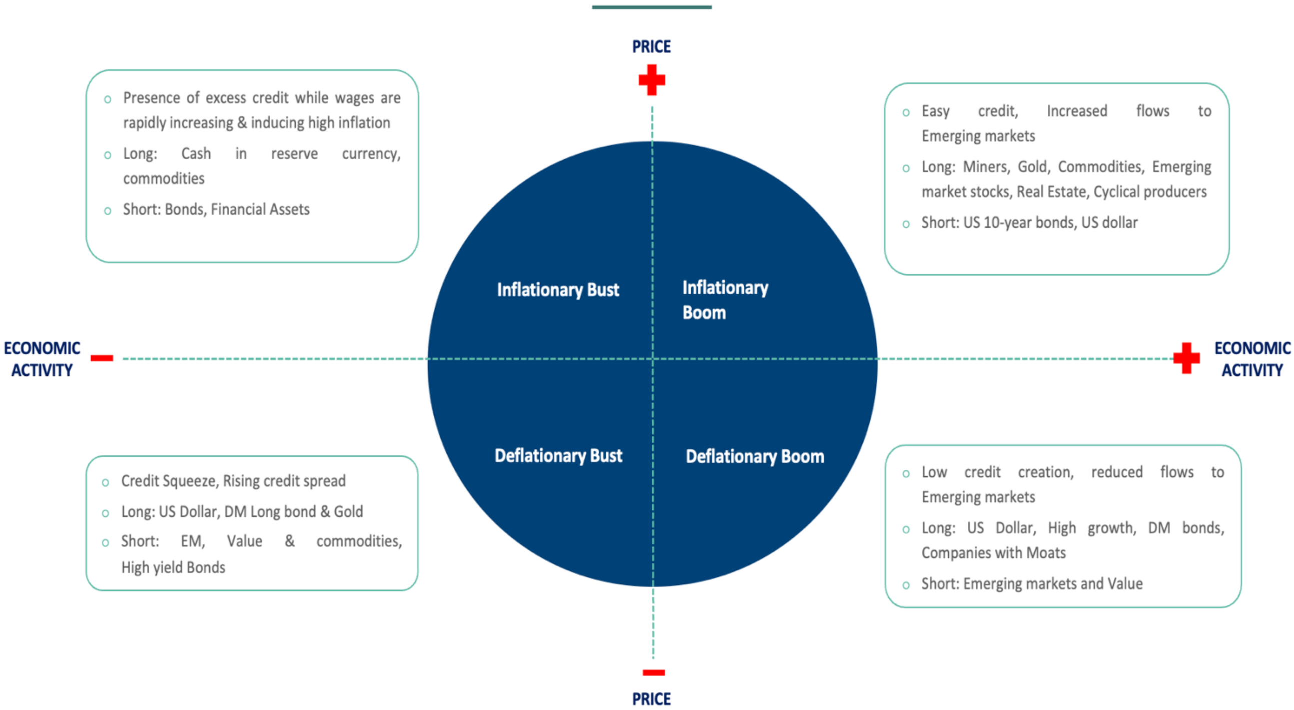
How did they do this deleveraging in the past?

- Yield curve control (1942 – 1951) i.e. forcibly not allowing market to decide the yield and fixing the yield (very much against free market policies). At this forced low rate, the government continued issuing debt at that level, and spent that money for war efforts and jacked up inflation. But the real rate of interest was kept below the rate of interest. So, the real rate of inflation was actually way higher. This was monetary repression.
- Post 1980s, the government again reduced rates to get leveraged. Times were good.

What are they going to do?

- The FED will not stop QE, they will only slow it down. Since they have to service the debt.
- Most countries will inflate their debt. Only governments can do this.
- They will issue the new debt at lower rate and let inflation go higher. How it is done- Government drops interest rate and lets inflation go up. So, when you let inflation go up, you can see that the value of your assets goes up. For e.g.: Say you have a house today. So, you will pay of your debt as long as your house value notionally keeps going up. Any hard asset, as long as it keeps going up, you can pay off that debt by paying your EMIs or by selling that asset at a higher price. Government does the same thing. Government keeps printing money- will keep interest rates low- will keep Inflation high- High inflation means higher tax receipts and it will be able to reduce the quantum of debt in the system.
- This is literally what debasement of currency looks like. This is the reason why we are seeing valuations of assets which protect against inflation go higher and higher. Because money does not care about profits, it cares about protecting itself from debasement. This is what financial repression looks like but it is still possible to beat the market in this. Guess what, Warren Buffett had his highest returns during this period.
- So, the government is able to get that ratio Debt/GDP back to a lower number simply by using inflation. Remember, both these figures i.e. debt and GDP are in nominal terms. So, you can increase your GDP using inflation rather than actual productivity and your debt increases by a lesser percentage (coupled by keeping the interest rate below inflation). If denominator increases faster than the numerator, the ratio reduces!
- In times like these, who gets hurt? The savers! And how do you protect yourself? By owning assets- Stocks (specific), real assets etc.

General Trend expected for the next 10 years



Source: Ritesh Jain, NriZen