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ARTICLE

Too Soon? Pandemic Policy Response Raises Risk of Inflation

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Key Points

- Today's public health response to the COVID-19 disease is causing mass unemployment and precautionary savings, which depress demand and exert downward pressure on inflation.
- Today's fiscal and monetary stimulus is necessary medicine to prevent a larger than necessary economic contraction and consequent human suffering.
- Longer term, exploding deficits, soaring debt, and money printing raise the risk of inflation as of a toxic side effect.
- As we approach the coming recovery, investors should be on the lookout for cheaply priced inflation protection, including REITs, small-cap stocks, commodities, and emerging-market value stocks.

Now is too soon to worry about inflation from a public policy perspective given the immediate humanitarian need for disaster relief. Many millions of newly unemployed people need cash now to pay bills and just to buy food for themselves and their families. Hesitating to provide help now because of worries about inflation later would be beyond the pale.

Now is too soon, also, to expect to see a rising Consumer Price Index (CPI). Rising unemployment and precautionary savings are currently exerting downward pressure on inflation. According to the US Bureau of Labor Statistics, CPI fell by 0.4% in March. Longer term, however, exploding deficits, soaring debt levels, and money printing raises the risk of a toxic bout of inflation. Investors should consider the opportunity provided by declining inflation expectations to diversify into newly cheap inflation-hedging assets.

Falling Employment Is Deflationary

A shocking number of people are losing their jobs. Approximately 17 million people across the United States filed for unemployment insurance during the three weeks ended April 4, representing almost 11% of the 150 million people working in March (FRED, 2020). Add expected new claims for the week of April 11 and the unemployment rate is likely near 15% and climbing fast. Layoffs and furloughs will continue in coming weeks. Seemingly outlandish estimates that the peak unemployment rate will hit Great Depression levels (Bartash, 2020) of 20% or even 32%[1] later this year now seem uncomfortably plausible.

Have you increased or decreased your spending over recent weeks? When people lose their jobs, they must immediately cut back discretionary spending. More important, those who keep their jobs reduce spending to increase precautionary savings. This sudden decline in spending reduces aggregate demand more than aggregate supply and thereby puts downward pressure on the prices of goods and services.

Unsurprisingly, inflation expectations have dropped. The current 10-year breakeven inflation (BEI) rate of 1.2% is below the Fed's 2.0% target. Note that the market is pricing a prolonged period of below-target inflation. The expectation for the inflation rate from 2025 through 2029 is well below target too. Specifically, the five-year BEI rate five years forward is only 1.4%.

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Exploding Deficits

We must act. Fiscal stimulus is a necessary humanitarian effort to keep our economy functioning through this COVID crisis. By propping up aggregate demand, we aim to prevent a larger than necessary decline in economic output. Failing to do so would risk a depression and profound human suffering.

When tax receipts tumble and government spending soars, deficits explode. Consider tax collections. Income and employment tax receipts are falling alongside declining employment. Sales tax receipts are falling in line with lower spending. Capital gains tax receipts are falling because stock prices have dropped.

Government spending is rising even faster than tax receipts are falling. Congress recently passed the CARES Act, which directs the US Treasury to spend an extra $2.2 trillion this year.[2] This fiscal stimulus includes $500 billion sent directly to individual taxpayers, $350 billion in forgivable loans to small businesses, and $260 billion for emergency unemployment insurance. Congress is already preparing another round of fiscal stimulus at an additional $1 trillion (House and Wasson, 2020). More may follow.

How much new debt will be created? Goldman Sachs estimates that the combination of already enacted fiscal stimulus along with additionally required disaster relief legislation will raise our deficit to $3.6 trillion this year and $2.4 trillion next year for a total of $6.0 trillion over just these two years (Rosenberg, 2020). Given that we in the United States were already on track for $1 trillion annual deficits before the COVID crash, that's a tripling of our deficits.

Who will buy all of this new debt? The Fed will.

A $5 Trillion Bazooka

In July of 2008, early in the global financial crisis, then Treasury Secretary Hank Paulson told Congress: "If you've got a bazooka, and people know you've got it, you may not have to take it out." As the global financial crisis proceeded, Hank had to use his bazooka.

In March of this year, the UK newspaper *The Telegraph* headlined its report on the ECB's announcement of a $750 billion Euro Pandemic Emergency Purchase Program with "ECB Brings 750 Billion Euro Bazooka to Coronavirus Fightback."

The CARES Act provides $500 billion for the Treasury's Exchange Stabilization Fund. Following the playbook from the global financial crisis, the Treasury, with help from the Fed, will lever up this half of a trillion dollars by 10 times (Cantrill and Wilding, 2020). The Fed now has the firepower to inject nearly $5 trillion into global capital markets.

Congress just gave the Fed a $5 trillion bazooka. The Fed will use it.

Printing Money Is Inflationary

The Treasury is now wiring newly created money directly into people's bank accounts. Even if "helicopter drops" of cash and the Fed's buying of $5 trillion newly issued bonds could maintain the nominal value of output and consumption, it cannot prevent the real value of consumption from declining.

Surely, you might think, we should be able to consume more than we produce during this unprecedented crisis. But how can we do so in aggregate? We are not an agrarian economy; eating our seed corn and prepper rations won't substitute for today's lost production. Nor will we be able to replace the lost output of goods and services by consuming imports from the rest of the world. All other countries' output is falling too.

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Real consumption must decline in line with the real value of output lost due to the cessation of productive activity. If today's money printing does succeed in maintaining the *nominal* value of consumption spending, many more dollars will be chasing a smaller amount of goods and services. The result will be inflation.

Crying Wolf

The boy who cried wolf is one of Aesop's more-famous fables. The moral of that story is those who repeatedly make false warnings will be disbelieved when their warnings are finally true. Are we crying wolf about an imaginary risk of inflation?

I don't think so. I explained in 2015 why quantitative easing (QE) was not then causing inflation and needn't cause inflation in the future. Quantitative easing creates bank reserves, which do not necessarily increase the money supply. Further, by paying interest on bank reserves, a central bank can effectively discourage banks from using those reserves to create money.

I also said: "Money printing is different from QE. Money printing is inflationary by definition. If the central bank rapidly prints a lot more currency and immediately puts it into circulation, then more money is chasing the same amount of goods and services" (Brightman, 2015).

To be clear, our worry isn't about monetary policy conducted by the Fed. We worry about fiscal policy conducted by Congress. We worry that future Congresses may become addicted to imprudent deficit spending. With the economy at full employment, $1 trillion deficits didn't cause inflation in 2019. If a tripling of those trillion-dollar deficits doesn't cause inflation in 2020 and 2021, will Congress choose to raise taxes and/or reduce spending in 2022? After the economy recovers to full employment, some level of government spending in excess of tax collections will be inflationary. Inflation is ultimately a political choice.

Mint That Coin?

Should we explore unorthodox policies? Yes, some of the ideas in the Automatic BOOST to Communities Act Policy Proposal (BOOST Act) merit consideration.[3] This Modern Monetary Theory (MMT)–inspired proposal to distribute debit cards to all US residents regardless of whether those people appear on the IRS database of taxpayers might solve today's problem of failing to get emergency cash to the least fortunate among us, particularly those without bank accounts.

While the entirety of the proposed BOOST Act seems unlikely to be enacted into law, it does clearly demonstrate what MMT means in practice. Specifically, the BOOST Act directs the Treasury to mint two $1 trillion platinum coins, thus dispensing with the current intermediate step of the Treasury's selling bonds to the market.

Of historical note, the $1 trillion platinum coin idea was first proposed back in 2011 to avoid the need to exceed the legislative debt ceiling. This fringe idea was then endorsed in early 2013 by Nobel Prize–winning economist Paul Krugman in a blog post titled "Be Ready to Mint That Coin" as a superior alternative to a US government default.

The key difference between the MMT-inspired BOOST Act and present policy is transparency. It would eliminate the complex and opaque process of the Treasury's selling bonds to the market while the Fed simultaneously buys a similar amount of bonds in its open market operations. No phony government debt would be created by the BOOST Act.

I appreciate the practical importance of central bank independence. I am on record as saying: "Relying on Congress to manage inflation through tax policy seems recklessly naïve regardless of whether it would be theoretically possible" (Brightman, 2019). Still, how does today's policy substantively differ from full MMT? Is debt owed by the Treasury to the Fed real debt at all? If the BOOST Act would be irresponsibly inflationary, why is the fiscal response now being applied *not*?

Is This Time Different?

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On the one hand, lessons learned from austerity in Europe following the global financial crisis warn against failing to provide necessary emergency fiscal stimulus (Fatás, 2018). On the other hand, history also teaches us that if government sends large quantities of cash directly to people for too long, financial crisis and inflation result (Reinhart and Rogoff, 2011).

Will policy nimbly pivot to prevent inflation? The Fed can't do it alone. Some combination of tax increases and spending cuts following the coming recovery will become necessary to prevent a spike of inflation. Will Congress understand precisely when to execute this fiscal U-turn? Will our politicians display the required foresight and courage? I worry.

A future bout of high and volatile inflation may prove to be a toxic side effect of today's experimental economic medicine. Risk of inflation in future years seems much higher than priced by today's BEI. As we approach the coming recovery, investors should be on the lookout for cheaply priced inflation hedges. TIPS remain expensive; REITs, small-cap stocks, and commodities have become interesting; and emerging-market value stocks are exceptionally cheap.[4]

Endnotes

1. Rates of 20% and 32% have been suggested by US Treasury Secretary Steven Mnuchin (CNBC, 2020) and the Federal Reserve Bank of St. Louis (Faria-e-Castro, 2020), respectively.

2. More information on the CARES Act is available at https://home.treasury.gov/cares.

3. Details of the Automatic BOOST to Communities Act are available at https://tlaib.house.gov/sites/tlaib.house.gov/files/Automatic Boost to Communities Act.pdf

4. Our long-term forecasts for over 100+ assets across global markets are available on the Asset Allocation Interactive (AAI) tool on the Research Affiliates homepage.

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