

# ECONOMIC NOTES

## AN INFLATION HOME RUN?

Milton Friedman said that monetary policy only gets you to inflation's first base

It needs to join-up with fiscal policy to hit a home run

Inflation in 2021 is dominated by big relative price changes but core inflation is moving higher with all items

The monetary and fiscal omens are warning of trouble ahead

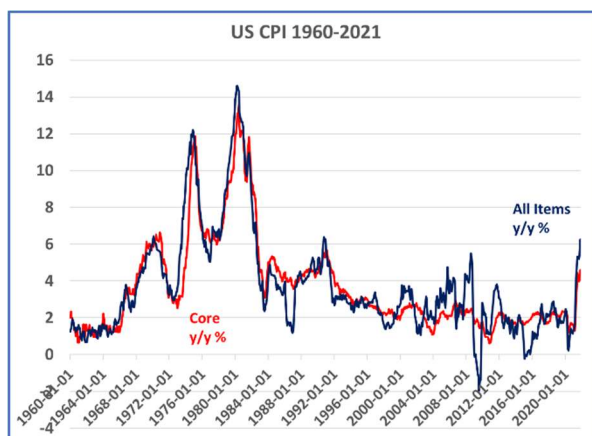
Inflation expectations are under threat the longer central banks leave it to respond

Things are about to get interesting

## INFLATION IS ALWAYS AND EVERYWHERE A MONETARY PHENOMENON

So said Milton Friedman, arguably the most influential economist of the twentieth century. But Friedman also remarked that monetary policy only gets you to inflation's first base, to hit a home run monetary policy needs to team-up with fiscal policy to pass that money directly to the economy.

US inflation has just hit 6.2% y/y for all items and 4.4%, y/y for core, its highest in thirty years. We know that much of the inflation seen to date is traced to a cluster of big relative price increases that are distorting the overall index.



We also note that this is the result of the Covid-19 disruption, and that it would take a sustained negative supply shock, with full-on policy support for demand, for inflation expectations to

move higher. Anecdotally, there is talk of people protecting themselves against higher inflation, and employers raising wages. Wages don't drive inflation they reflect the inflation already there so this is worrying news.

It is clear that with inflation now persistently high, with demand well supported, and negative supply shocks persisting across many sectors, macro policy needs to be scaled-back. Monetary policy will be pulled-back sooner than fiscal policy, especially in the US where fiscal policy is gripped between opposing political teeth. Canadian fiscal policy is focused on funding a normative social give-away, and economic policy has been cast aside like an ostrakon. Canada's supply side efficiency decays with each passing day and fiscal stance is wide-open.

Rereading Friedman's inflation analysis should make macro economists uncomfortable. Interest rates in the advanced countries with hitherto low inflation are stuck at the zero lower bound, and many countries have very large primary deficits. Private sector competition is pitiful, prices are rising to boost profits, and investment is declining. Little wonder Larry Summers is anxious. I share his worry.

Japan has shown us that in uncompetitive economies interest rates sink, and the debt ratio can easily rise well above 200% of GDP. The only thing keeping advanced country debt ratios in the low 100's is low interest rates. Persistence in above target inflation suggests interest rates will have to rise, as the US can generate inflation where Japan could not.

Without some pull back, easy money and easy fiscal has opened the field for the inflation players to score a home run. For inflation expectations to be contained, and for the run-up in relative prices to dissipate in the years ahead, monetary policy has no choice but to tighten. The Bank of Canada and the RBA have chosen to end balance sheet expansion before moving interest rates up. The Fed may not have that luxury with fiscal stance at such an expansive level.

Central banks can do quantitative easing at any interest rate, so one cannot rule out they can change interest rates at any balance sheet size. A swift interest rate increase even as "tapering" is incomplete is possible if the Fed loses its nerve

### **Whither Monetary Dominance?**

Each arm of macro policy has a specific role, where monetary policy manages inflation and fiscal policy manages debt stability. So long as fiscal policy stays in its lane and contains the debt ratio, monetary policy is free to do what it needs to do. It is only when monetary policy takes its marching orders from fiscal policy that inflation management passes to fiscal policy, which is simply not up to the job.

So where are we today? First, is monetary policy now in the business of financing government spending. The answer is no, not yet. Is monetary policy being "de-fanged" by the need to sustain financing of government debt? No, not yet but one's confidence in the ability of monetary policy to remain independent erodes the higher debt goes, and the more reliant the treasury is on low interest rates.

The 2020 emergency action by monetary and fiscal policy does not represent the explicit cojoining of monetary and fiscal policy that Friedman argued was necessary to hit the inflation home-run. In his time, governments used direct money financing to meet expenditures, and used higher inflation as a tax. Citizens wanted a big state but didn't want to pay for it.

In the 1960s and 1970s, a sustained money financing of fiscal expenditures over many years, created excess money growth that made its way directly -- through the treasury -- to household bank accounts. Private sector lending overwhelmed the real economy's ability to absorb it; prices went up and inflation became embedded in expectations to dig right in.

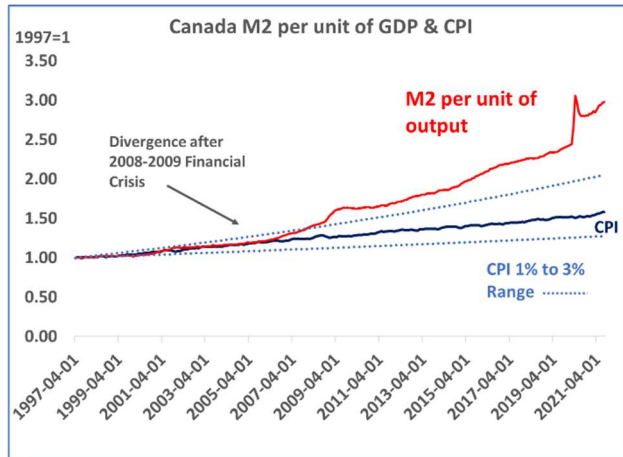
### **The monetary omens are worrying**

Friedman's favourite measure of the link between money and inflation was to show an index of money per unit of GDP (nominal money supply divided by real GDP) and an index of inflation. This measure was uncannily accurate in predicting future inflation with a lag of about eighteen months.

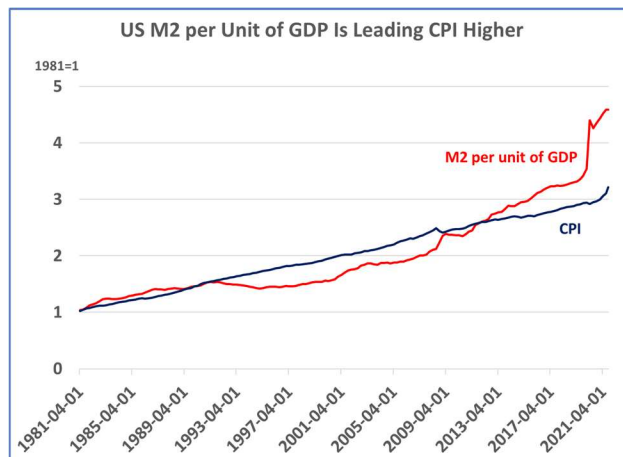
I have recreated this relationship for both the U.S. & Canada using M2 for the U.S. and M2++ for Canada. For Canada I have shown this measure alongside the consumer price index and the CPI cone that traces the path proscribed by top and bottom of the Bank of Canada's 1% to 3% inflation target.

Focusing on Canada, there is remarkable coherence between this measure of the economy's ability to absorb money and the CPI, and the two tracked very closely from 1997 until the summer of 2006 after which the two measures diverged. The divergence widens dramatically following the large central bank balance sheet expansion in response to the Covid-19 emergency.

Interestingly, the increase in money per unit of GDP did not lead to higher inflation following the 2008-09 financial crisis, because it did not flow to the real



economy via the treasury. The excess liquidity remained within the banking system. While some leaked into mortgage borrowing and higher house prices, it did not feed-through to a broad basket of prices. As housing is a service, rents will eventually rise but the lag to CPI is likely long.



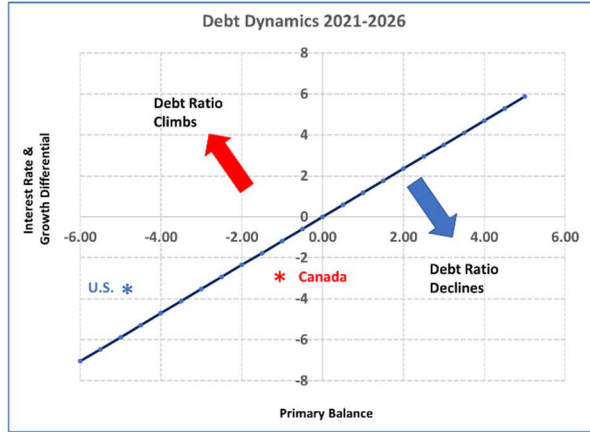
**Where are we going?**

The last big emergency borrowing program to

join explicitly monetary and fiscal policy occurred in the second world war. To sustain war financing, the Federal Reserve was tasked with keeping interest rates at a very low level and financed all short-term borrowing. Inflation eventually flowed-through, and it took a 1951 accord between the Federal Reserve and the Treasury before the Fed was free to pursue inflation control.

Today's starting point is quite different. U.S. monetary policy is not currently tasked with a fiscal mandate, and is free to pursue its joint inflation and employment goals. The Fed is not been required to explicitly fund government expenditures, buying bonds from the public not directly from the treasury. And, while debt ratios are high, debt dynamics are favorable for sustained deficit financing, and the growth in the debt ratio is neither economically threatening nor unsustainable at current interest rates. As long as debt dynamics are benign, Fed independence is assured.

Government debt dynamics are driven by the rate at which debt accumulates relative to the rate of GDP growth. The rate at which the debt ratio grows is thus a function of the spread between interest rates and GDP growth. If interest rates are above GDP growth, then a primary surplus (revenues less expenditures before debt interest costs) is necessary to stabilize debt. Today, interest rates are below



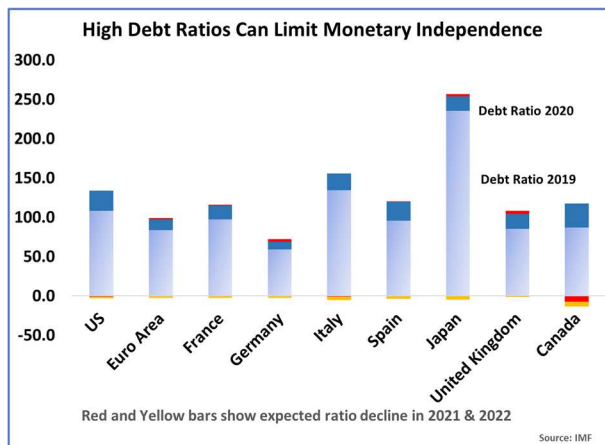
the rate of GDP growth so deficits are not especially threatening to debt sustainability.

Could that change? Yes, but likely without warning. Over the next five years the IMF estimates that the U.S. interest rate GDP

growth differential will average -3.7% but the primary deficit will average 5.3% of GDP. The debt ratio will continue to climb. As the chart shows, the U.S. is not close to stabilizing its debt ratio. In contrast, Canada has more favourable debt dynamics keeping the Bank of Canada firmly in the driving seat. A floating exchange rate means that Canada can shield itself from the US inflation pulse. Inflation might be world-wide but it is not international as each country gets the inflation it chooses.

### Is a monetary fiscal fight ahead?

Today's debt ratios look very high compared to history and are have passed the limits prior generations thought tolerable. Yet there is little pressure to stabilize the debt ratio while interest rates are much lower than the rate of GDP growth.



For fiscal policy to tack true to its assignment, and for monetary policy to meet our expectations of it, achieving debt sustainability will require a reduction in the primary deficit in the years ahead.

The epic US, UK and Canadian disinflations that spanned the 1980s and 1990s required painful fiscal adjustment, and it took immense economic pressure from tight monetary stance to force politicians to act. Central bankers dread a fight with fiscal policy, and if they want to avoid it they had best act now. Things are about to get interesting.

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