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Inflation: The Case for a Breakout

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As one Wall Street maven says, "It is NEVER different this time," and "It is ALWAYS about character."[1] I apply this filter to the inflation outlook and conclude that we are complacent and not yet willing to do what it will take to contain a debilitating, divisive and stagflationary rise in consumer prices.

We are complacent because the aggregate money supply has not grown faster than gross domestic product. We experience the creative destruction of the shared economy as consumers and find it pretty neat, cheap and disinflationary. We imagine one day there will be an app for everything; we'll get as much detail as we need just in time from an automated persona like Siri or Alexa. We feel warm and safe in the bubble since we look at aggregates that mask the impact of the huge forces at work.

The economy is really about networks of productive activity, of work teams that turn resources into goods and services through intermediaries like public and private corporations, associations and government. It's an ecosystem that learns, innovates, grows and distributes rewards. It is quite robust, but it depends on political leadership—mainly through regulatory and tax choices—to define the sandbox within which we all compete. In short, whatever statistics we watch about the average wage earner, the widening gap between people who consider themselves winners and losers fuels political polarization, which in turn invites destructive policy such as tariffs and trade wars.

By this I mean, of course, the pattern of decisions to penalize global business—from pulling out of the Trans-Pacific Partnership, to undermining the North American supply chains that have flourished under the North American Free Trade Agreement, to aluminum and steel tariffs, to who knows what's next? These invite reprisals and at best create opportunities to substitute products. What has been missing is the commitment to share the benefits of free trade more broadly within our sandbox over many administrations and many years. Measures that might help in this area include corporate and public investment in apprenticeship programs and useful infrastructure. In the short run, higher trade barriers will mean higher prices at the retailers for consumer products, which will translate into wage growth, which is approaching 3 percent. This is the bad kind of inflation since it comes with no pickup in productivity.

The unemployment rate continues to break through whatever red lines for nonaccelerating inflation rate of unemployment (NAIRU) that may have been set back in the crisis; labor force participation has certainly improved. It seems that we are accomplishing as much as one can expect from monetary policy with a cautious data-driven Fed. However, fiscal policy has tilted toward tax cuts and spending increases, which are stimulative in the short run. The test will be how much of it translates into real growth and how broadly that growth either spreads or goes to fuel an asset price bubble.

A relatively high old age population is not necessarily disinflationary. Entitlements for health care and pensions can grow larger than the savings this group has generated. Theoretically governments can fund them with unlimited tax increases, but in real life, the tax base can move to a warmer climate and let inflation make up the difference.

The Fed has started on a "stealth tightening" program of allowing a portion of its Treasury and agency holdings to mature at a pace of up to $30 billion/month in April 2018, rising to a cap of $50 billion/month from October 2018. While it could take seven years at this pace to reduce the Fed's $4.5 trillion balance sheet to precrisis levels, the reduction in demand should boost Treasury yields. By itself, it is clearly a manageable and needed adjustment. But the Fed is not the whole picture. Counting intragovernmental holdings (like the Social Security

trust funds), Treasury debt totals about $20 trillion. About 40 percent of outstanding Treasury debt matures within five years, while the average interest rate of outstanding federal debt is 2 percent.[2] Two percent of $20 trillion is $400 billion of interest expense. Replacing $10 trillion of it at 5 percent raises the annual cost to $700 billion. That's expensive.

At the same time, foreign central banks held $6.3 trillion of Treasuries as of December 2017, and of that, more than a third was held by the central banks of Japan and China. If central banks and sovereign wealth funds were to shift a meaningful portion of their holdings to Euros or yen, that could add to upward pressure on market rates and a weaker dollar. The "perfect storm" aspect of this scenario is that trade barriers and global trade friction reduce the export benefit opportunity from a weaker dollar and leave us with just the high import costs. A weaker dollar increases commodity and food prices, which impacts anyone who eats, drives or turns on the lights.

All of this assumes that the world muddles through all the geopolitical risks without an escalation in the cost of a prolonged, large-scale military deployment. Given the other economic forces at work, higher military spending could be inflationary.

So, are we "on the cusp of an inflationary cycle as in 1979–1981"? Not yet, but the factors that lead to such a bad outcome are on the march. High inflation is a failure of the fiscal and political system first of all, and on that front, "it is ALWAYS about character." What would help is a functioning political center. Imagine a world where the leaders of opposing political factions are able to set consensus compromise goals and govern together.[3] Then some real progress on our fiscal challenges would be likely. Let's work on that.

Bottom line, the risk is that we will keep interest rates low despite inflation. As half the current debt matures and rolls out of 2 percent securities, the non-negotiable cash needs due to rising entitlements, lower tax revenues and global uncertainty could mount. Despite our best intentions to keep inflation contained, higher inflation could be seen as the lesser evil. ■

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ENDNOTES

1 Harley Bassmen. n.d. *The Complexity Maven*. *http://www.convexitymaven.com/themavenmantra.html*.

2 U.S. Government Accountability Office. *Financial Audit, Bureau of the Fiscal Service's Fiscal Years 2017 and 2016 Schedules of Federal Debt*. Publication GAO-18-134 November 2017, p 26.

3 As we recently saw in the renewed coalition between Angela Merkel's CDU and Martin Schulz's SDP in Germany.