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Taking Stock: Are We Setting Ourselves Up for High Inflation?

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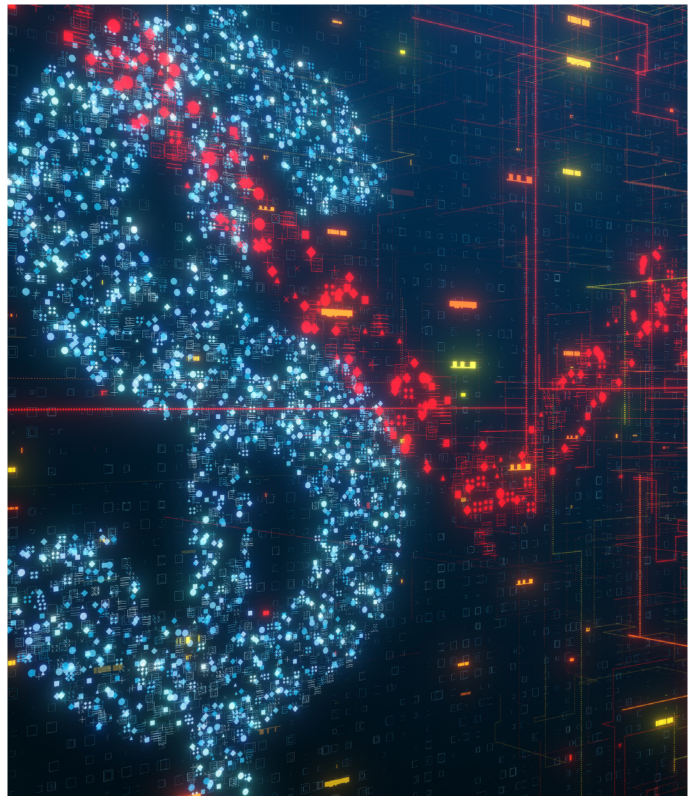


When the global financial crisis of 2008–09 was in full swing, the price of gold at one point jumped dramatically over the course of several hours. The U.S. Federal Reserve announced another policy initiative that according to traditional economic and financial thinking would be highly inflationary.

The price of gold receded over the next several days as investors correctly surmised, based on the slack that existed in the economy and financial system, that the Fed's policy should not be too inflationary if at all.

Over the ensuing years, the Fed's prevalent policy of buying debt instruments introduced liquidity into the financial and economic system but occasionally also raised the specter of inflation. As subsequently observed however, the liquidity introduced was sorely needed and it did not produce inflation at the consumer level. Instead, it led to asset inflation as real estate prices revived, the stock market rebounded and interest rates declined as bonds were more widely purchased.

The Fed also put itself into a backstop role. Investors became more confident that the Fed would step in once again if another crisis developed. Other central banks adopted a similar policy as these saw the Fed's approach as being successful overall.

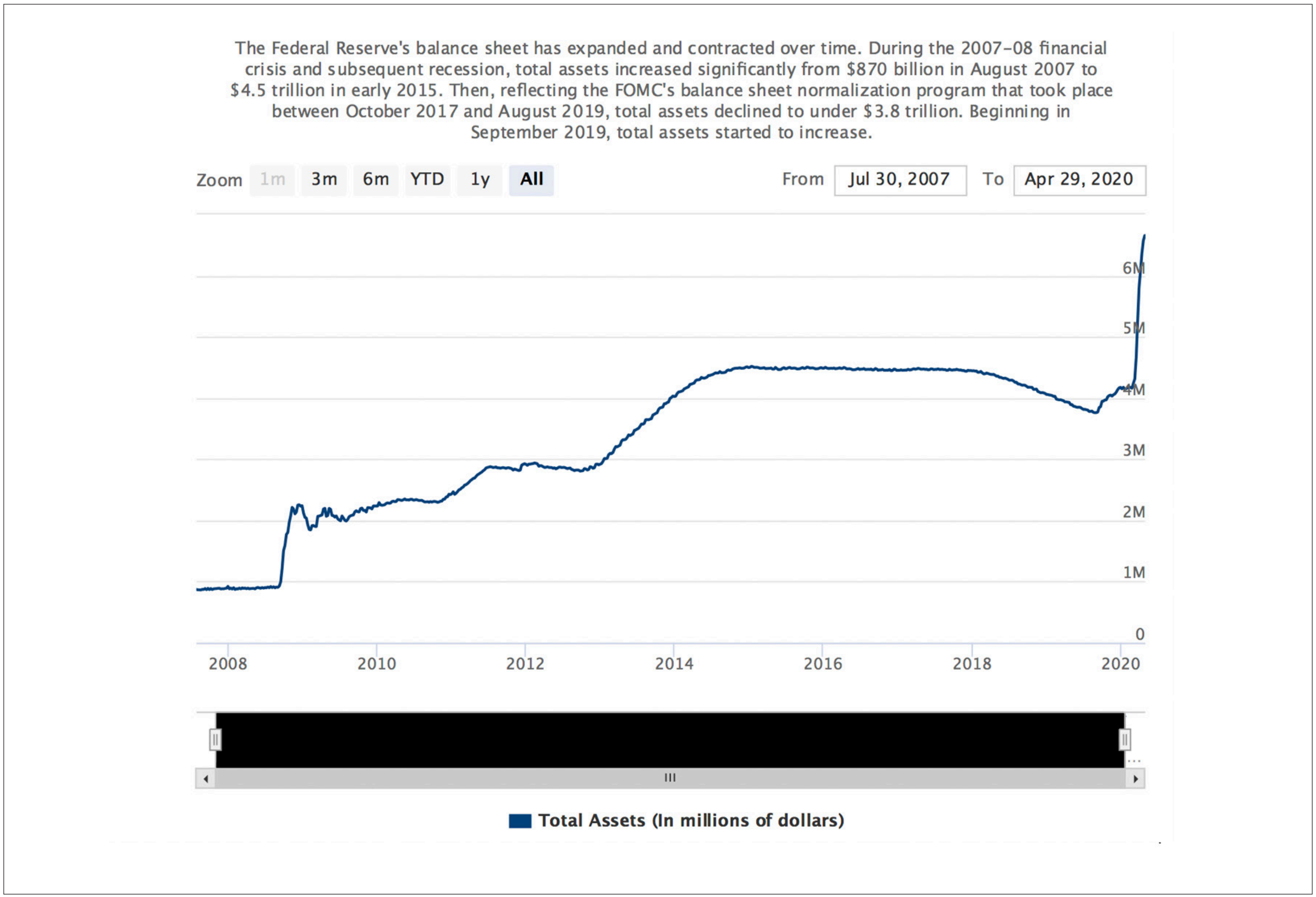
These central bank actions helped make high debt levels look less troubling. The obligations appeared sustainable. Under natural forces of supply and demand, investors would demand a higher interest payment if the supply of debt is high. But when a central bank becomes a major buyer of these securities, excess supply does not pose as much of a problem and the interest rates charged or demanded by investors become suppressed.

Given the current pandemic crisis, many governments around the world are stepping forward aggressively to financially support their domestic economies. We are looking at trillions of dollars in stimulus and relief to be financed ultimately through new debt. As was witnessed after the global financial crisis, a policy of austerity to balance budgets as practiced in parts of Europe did not truly work, so it is preferable for governments to spend.

Many countries were already dealing with high debt before this pandemic outbreak. As a result of this crisis, debt levels of many more countries will be pushed beyond realistic limits, points at which this new debt is never expected to be repaid.

Given this current pandemic crisis, central banks will once again become a major purchaser of the excess bond supply which will result in keeping interest rates low. The U.S. Federal Reserve for example (as shown in Figure 1) has already expanded its balance sheet to well over \$6 trillion, up from just below \$4 trillion a few months ago, and from \$870 billion before the Global Financial Crisis of 2008–09.[1]

Figure 1
U.S. Federal Reserve Balance Sheet Expansion



This does raise the question as to whether the intervention of central banks will at some point break down and no longer produce the hoped-for results. After all, it is rather strange to have one agency of government (even though technically independent) buy the debt of another government entity. But it is expected that this central bank policy will continue globally, until it no longer works.

HIGH DEBT—HOW DID WE GET SO FAR?

The notable economist John Maynard Keynes of the 1930s proposed a different approach to dealing with economic downturns. I would summarize it this way. In bad economic times, a government can borrow and spend the money to stimulate the economy. In good economic times, the government pulls out the money (such as through taxes) and pays the debt back.

This Keynesian approach is very simple and makes sense. It should flatten the peaks and valleys of the economic cycle. Previously, adding debt to government balance sheets was not viewed favorably.

However, as governments began to adopt this new way of fiscal thinking, the principles began to change. Governments would be spending all the time and borrowing all the time.

In good economic times, governments would still spend to make a strong economy even stronger, since that would help them get re-elected. Generally, voters hold a detachment to government debt, considering it to not be theirs. If a government did attempt to reduce debt, it would not get much credit for its heightened sense of fiscal stewardship. The government would appear less successful. If social programs and spending initiatives were cut these would not often be viewed positively. As we probably know, it is preferable not to give people something than to give them something and later take it back. Such is the case with the voter electorate.

Many people benefitted from this higher level of government spending, especially as social programs were introduced and expanded. But the result of this new government behavior was that many countries reached debt levels that were high (albeit still manageable). This was true until the global financial crisis of 2008–09 and when the Greek debt crisis of 2015 arose. These events pushed many countries towards debt levels that were less sustainable as the economies also suffered.

CASE STUDY—HYPERINFLATION IN VENEZUELA AND MODERN MONETARY THEORY

In 1998, Hugo Chávez was elected president of Venezuela. The government enjoyed a significant rise in revenue in large part due to the increased export of oil and related products. In response, Chávez used some of the new income to expand social programs. These helped reduce poverty and improved the health of the country's citizens.

Even though a certain degree of financial mismanagement, corruption and overspending was also occurring, significant problems did not surface during the first decade. But eventually the country began to experience quickly deteriorating financial conditions and a growing shortfall in the government's balance of payments. In response, Chávez in June 2010 took strong action in an attempt to mitigate and possibly reverse the economic and financial decline.

Coupled with subsequently falling oil prices, economic and financial conditions within Venezuela worsened. The country eventually faced hyper-inflation, supply shortages, social unrest, increased poverty and starvation, national protests and a string of political crises. The country defaulted on its debt. The problems in Venezuela are still ongoing.

Venezuela had embarked on a more traditional approach in dealing with its economic crisis. It also introduced price control measures. All of its policies could not reverse the loss of confidence in the country, stop rising inflation, and prevent further economic deterioration and debt default.

However, it would be interesting to step back and speculate on how the situation would look if the Venezuelan central bank bought back government debt, as we witnessed with many of the major economies in the past decade.

These actions sometimes fall under the label Modern Monetary Theory (MMT). Under MMT, a government can supplement the shortfall in paying its obligations through debt rather than taxation, where the new debt is significantly absorbed through the central bank.

Whether investors would fully accept such a central bank approach for a smaller country or economy such as Venezuela is somewhat debatable. But such an action would prevent any bond default. The central bank would buy any debt that no one would want or purchase any supply investors could not absorb.

It could delay a crisis in investor confidence. A budget imbalance where government revenue is not sufficient to cover all of its obligations becomes less visible to many investors, since they may not fully understand what is taking place.

Adherents of MMT do cite that this approach has inflation risk. Therefore, they would argue that raising taxes and issuing additional bonds will help take out the monetary excesses once inflation appears. In addition, other mechanisms adjust in reaction to the imbalance of payments such as the currency exchange rate.

Applying an MMT approach does help to produce stability in the bond market as the net issuance of bonds to the public does not have to change drastically. Depending on the volume at which bonds are purchased by the central bank, the interest rate charged is somewhat controlled. Bond defaults never need to occur.

However, we should be aware that no fiscal or monetary policy provides a "free lunch." In the case of Venezuela, even with the application of MMT, we would anticipate a point where foreign investors for example, observing the internal conditions of the country, will not want to invest in the country's securities at previous prices or at any price. They would see the balance of payments continuing to be too imbalanced and not improving. Trade is faltering. The currency exchange rate begins to suffer. Confidence in government policy and the domestic economy would still decline.

Despite an application of MMT, there would still have to be a breakdown. It cannot compensate for fiscal mismanagement. High inflation would result and despite any efforts to stimulate the economy, most policies would fail.

However, it does appear that MMT could have softened the blow of the Venezuelan crisis in the initial stages, as big financial and debt impacts could have been avoided and the transitions or adjustments could have been more gradual.

Venezuela would not be a special case. Any economy would begin to suffer when its excesses go too far, regardless of what economic or monetary theory is being applied. This should provide a warning to us that central bank mechanisms cannot compensate indefinitely for the problems or mismatches occurring in other areas of government or the economy.

REVIEWING THE WORLD OF THE PAST 10 YEARS

As we have probably noted through presentations we personally attended or from items we have read, many countries in the past decade no longer had the reserves to deal with another emergency. Central banks became the mainstay to absorb the higher levels of debt governments were now incurring—otherwise the supply of debt was too risky and too enormous for private investors to absorb and accept.

The purchase of debt instruments by central banks would normally be considered inflationary as they would introduce more "money" into the financial system. Beneficiaries of the new debt were the issuing governments. Through their spending, governments would be engaging in policies that will normally be inflationary.

But our global economy has also been experiencing a number of deflationary pressures at the same time. Demographics have been a negative. For many sectors, industrial capacity had still not reached high levels. Various financial crises including Brexit reduced economy activity. Cheaper labor and production costs in other parts of the world kept prices of many consumer goods low. Central banks have operated under a backdrop where rather inflationary policies were largely offset by deflationary influences.

The current pandemic will have deflationary implications. Some have postulated that this pandemic could have major ramifications for the economy for two or more years. This will depress economic performance locally and globally. Under these conditions, central banks will be induced once again to take a very active role.

Obviously, our world can change dramatically. Global demographics have suggested that interest rates would remain low for a long time because we have an aging global population that gradually consumes less. But this can now change in the not-too-distant future.

Government debt now has to increase dramatically. History shows that pushing domestic debt too far will undermine an investor's confidence to sustain that financial system. So far central banks have been able to maintain and restore stability in many of the economies they oversee. But that does not mean it will continue to work indefinitely.

It is hard to say when a high debt level is overly high, especially when a central bank is involved. But it should raise concerns when a government realistically cannot pay it back. So far that is not something that is taken seriously for many financial systems.

CAN THE COST OF THE PANDEMIC BE COVERED THROUGH HIGHER TAXES?

Governments are facing deep drops in revenue while also incurring the unanticipated costs of any stimulus and relief they provide. The revenue of most governments comes through taxes.

Could governments pay down debt through additional tax revenue? For examination and illustration purposes, consider U.S. data. The U.S. is not in any particular better or worse shape than many other countries, but it has good information for us to examine.

The U.S. total revenue for fiscal 2021, most of which comes from taxes (prior to the crisis' impact) was estimated to be \$3.8 trillion.[2] The U.S. federal government was expected to still run a deficit of almost \$1 trillion (i.e., \$966 billion).

The current amount of U.S. government stimulus has a price tag of approximately \$2.2 trillion, and there could be additional spending to come. Considering the decline in tax revenue that is now expected, the U.S. government will likely have little to nothing left to fund its regularly scheduled annual activities. Therefore, the additional costs will have to be covered through additional debt. If the U.S. were to double the revenue it receives through taxes, it may only be able to break even for its current fiscal year.

Of course raising taxes faces a number of obstacles. It will face impediments from the political process. Taxpayers will protest if taxes rise substantially. For any political party, raising taxes too much could be political suicide. In addition, higher taxes will slow the economy.

The biggest problem is the numbers are just too large. The amount of money required is too high. The cost of this pandemic is proving very expensive. Can we realistically double the revenue a government receives through taxes, even if we spread the tax increases over a decade or so? The specter of increasing taxes raises a number of challenges.

A popular mantra that also arises occasionally is that we should tax the wealthy. But we need to realize that this group is not earning enough or is wealthy enough to cover all of the country's financial needs. Consider their assets.

The number of billionaires in the United States was reported to be 609 in 2019.[3] The number of millionaires in the U.S. was reported as 18.6 million (i.e., a net worth of \$1 million or more).[4] The U.S. total federal debt could reach \$30 trillion as a result of this crisis. If we take \$1 billion from each billionaire and \$1 million from each millionaire, this would raise about \$19.2 trillion in new revenue.

The U.S. could then whittle away over half of its federal debt through this approach. But this would require a seizure of assets (an extreme measure) since these persons do not make a similar amount of income annually (i.e., earn only a fraction of their net

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worth as income and for which they are already paying taxes). Additionally, after the asset seizure, many of these people will have almost no net-worth left. Having a net-worth of $1 million is also not a comfortable position for many people anymore, as they have health concerns and find that the cost of living keeps increasing.[5] A million dollars today is not that much, so if we just consider multi-millionaires (i.e., those with a net-worth of $5-30 million), the number of persons in this category falls to 1.05 million.[6]

We do not have a lot of room to cover costs through taxing the wealthy, since there is not much of a base to work with in this group. We should also not forget the impact of estate and inheritance taxes that are already pending on any assets.

Raising taxes appears to be a non-starter for a variety of reasons. The amount of new tax revenue required is simply too big. This will be a dilemma faced by most countries around the world.
It would, therefore, be best for any government to assume a larger amount of debt and hope that, through the help of central banks, it will be able to manage it.

INFLATION IS THE NASTIEST BUT POTENTIALLY THE ULTIMATE SOLUTION

No one truly likes inflation. It hurts people and economies. It creates uncertainty. But traditionally, it is one of the ways that puts a government's financial system back into balance.

Traditionally, if a government could not pay back its debt, the debt either had to be extinguished (such as through default) or devalued (such as through inflation). Given the central bank approach today, bonds need not default, unless we are dealing with a government or central bank that is taking a totally different direction (as was the case with Venezuela). That means that inflation could be the only real solution if debt and the ability for a country to service it, runs out of control.

Default is a problem because it damages the credibility of the borrower. It destroys the confidence of the lender to lend once again. But it has been one of the previous ways a government could put its revenue back into synchronization with its expected outflow.

Inflation is another solution which is a subtle form of default. The lender was expecting to receive a return of capital and earn interest payments that had a certain real value in terms of purchasing power. Through inflation, a government can receive an increase in revenue in nominal terms, while reducing the value of its debt in real terms, since most of its debt was issued at a pre-determined value non-indexed to inflation.

WHAT CAN WE EXPECT GOING FORWARD?

Central banks will accommodate the higher levels of debt incurred as a result of this pandemic. They will seek to keep interest rates low so that the governments could afford these obligations. Central banks can finance new debt obligations by buying them.

But we cannot rule out that inflation can become a problem eventually (so far we have just experienced asset inflation). Central banks can only go so far. We could find that there will be a crisis of confidence with respect to various countries in the foreseeable future. These could have ripple effects around the world (contagion) and raise concerns about which country will be next, even if another country is in better shape.

Our western economies have been able to enjoy a certain level of stability despite the challenges of the past decade. But we need to be on guard for a potential shift in the financial and economic situation globally and with respect to various countries.

If inflation does become a problem, central banks will have a difficult job on their hands and our sense of individual financial security will be jeopardized. We need to be prepared for a potential global shift where despite the effort of central banks, the levels of debt for various countries still become of grave concern and very high inflation begins to surface. ■

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ENDNOTES

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