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Economic Strategy

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How the budget deficits caused US inflation

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Fiscal deficit minus GDP gap equals inflation. Now the Fed must control the damage.

In this issue I want to talk about inflation in the US, where it has come from and what the cause is. I read a lot of commentary by journalists blaming the Fed for inflation. Still, where it has come from on this occasion has nothing to do with the Federal Reserve and everything to do with budget deficits. We can learn about the causes of US inflation by comparing the size of the budget deficit in the US in 2020 and 2021 to the size of the GDP gap, which is to say to the excess resources available in the US economy. These estimates of GDP gap are provided to us on the Federal Reserve database website. I compare them to the GDP deficit numbers on the same website.

The GDP gap was at its greatest back in the second quarter of 2020 when the Fed told us it was 10.77% of US GDP. At that time, the Fed told us there was a US budget deficit of 15% of GDP in that year. When you provide more stimulus than there is excess capacity in the economy (the amount of stimulus, minus the GDP gap) then the extra stimulus is going to go straight into an increase in nominal GDP. This means all that extra stimulus is going to go to inflation. What happened in 2020 was that there was a GDP gap of 10.7% and there was a budget stimulus of 15%, so 4.25% of that went to an increase in nominal GDP. It went straight to inflation.

What happened the next year? What happened was that we had the American Rescue Plan being introduced by the Biden Administration. A year later in the second quarter of 2021 the GDP gap has already fallen to an exceedingly small 1.7% of GDP. In that situation of this small GDP gap where the economy was almost recovered in GDP terms, the Biden Administration added the American Rescue Plan. This provided an additional deficit of 12% of GDP. That meant that 10.3% of GDP of that stimulus went to putting up not real GDP (because there is not enough gap in real GDP) but nominal GDP. It went straight to inflation.

That 12% of GDP in the American Rescue Plan includes handouts to Democratic states to get their government pension programs back in order. There are also long-term handouts (which have nothing to do with Covid) to the public sector education unions (which were great supporters of the Democratic party in the Presidential elections). This deficit of 12% of GDP in the American Rescue Plan saw 10.3% go directly to inflation. The problem of inflation is US budget deficits, not the Fed.

The Fed meeting of 16 March

After the Fed Meeting of 16 March, the Fed released the consensus outlook of the FOMC. GDP growth in the US in 2021 was 5.7%. The Fed expects that this year growth will fall to 2.8%, next year that will fall to 2.2%, and the year after that will fall to 2%. In the longer run, growth of the US economy that is sustainable is 1.8% of GDP. That number is the combination of population growth plus productivity growth. That 1.8% is higher than many countries in Europe. The Australian sustainable growth rate is around 2.5%. This is because our population growth is faster than in the US.

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The Fed expects unemployment to fall to 3.5% this year and to 3.5% next year and 3.6% a year after that. In the longer run they expect unemployment to be about 4%. That means they think they can hit their target on inflation with an unemployment rate of 4%.

The Fed thinks this year that PCE inflation, (the Personal Consumption Expenditure deflator) will be 4.3%. The core CPI in the US this year is about 6.4% now. Next year inflation both on the PCE and the CPI should be about 2.6% and in the long term it should be about 2%. Core inflation is about 4% this year in terms of the PCE but drops down to 2.6% next year and 2.3% the year after, so they are close to target by next year and the year after.

Fed Monetary Policy

My model says the equilibrium short rate for the Fed funds rate should be 1.89%. A consensus of all the members of the Fed thinks that Fed funds rate at the end of this year should be 1.9%. That is interesting because my model is driven not so much by inflation but where unemployment is.

So, the Fed is using the same kind of a model, where unemployment generates where wages growth is. This generates where they think core inflation will be and what they are using to determine their Fed funds rate. Where they think the Fed funds rate should be is 1.9% at the end of 2022. That is a rate hike at every meeting. They think the Fed funds rate will rise to 2.8% in 2023 and stay there, because that is where they think the stable long-term rate is.

Quantitative tightening – The Fed Minutes

Jay Powell said there was a lot of work put into the program at this Fed meeting of running down the size of the Fed balance sheet. He said that he expected this program would begin at the next meeting. The Fed Minutes, released on 6 April 2022, tells us that participants agreed to monthly caps of $60 billion in Treasury securities and $35 billion per month on agency mortgage-backed securities. This means $US720 billion of Treasury securities per annum, or 2.9% of GDP per annum, and $US420 billion of mortgage-backed securities or 1.7% of GDP per annum.

Taken together, this means that a flow of funds of around 4.6% of GDP per annum will be needed to take up this additional supply of securities. This suggests that the decline in the value of these securities, and the increase in yields on these securities, may be greater than many market participants now expect.

How the Fed Policy works

The mechanism of how Fed policy works in the US is different to how it happens in Australia. What happens is as the Fed funds rate goes up that number goes into private trading algorithms for mortgages. As the Fed funds rate goes up, this generates a higher equilibrium yield for mortgages. Long-term mortgage securities sell-off and mortgage interest rates go up. This is what drives a slowdown in the US economy. When you want to understand the US economy, do not look at the Fed funds rate; look at the mortgage yield.

I think that what the Fed is doing is vastly more powerful than commentators understand, it is a lot more than just putting up short rates. What the Fed is doing with its balance sheet is important, and what the Fed is doing is much more powerful than commentators believe.
Action in the Fed balance sheet is going to really bite, and you will see it really biting in mortgage interest rates. That is going to have an immensely powerful effect in slowing the US economy and reducing US inflation both next year and the year after.

Conclusion

Budget deficits, not the Fed, caused US inflation. Still, the Fed has powerful tools to control the damage that deficits have done.

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