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BLOG POST
Q&A Part 1
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Q: Will current deficits lead to an inflation tsunami?

Brian Lockhart, CFP®: Under the traditional framework for economics that ruled the world for centuries, you would have to say yes. When countries get overextended with debt it has several repercussions. Growth is stalled in the economy because an increasing amount of national capital is allocated for debt service and not used on more productive uses. Excessive debt levels also result in a lower level of confidence in the debt-ridden economy, causing their currency to lose value with respect to competing currencies. A vicious cycle ensues where growth slows and currency weakens until a country is forced to either default on their debt or print money to pay their bills. At this point inflation becomes uncontrollable and the economy is ravaged in a "normal" world.

We have not lived in a normal world, however, since coming out of the financial crisis of 2008. Debt levels no longer matter if a country's Central Bank is willing to monetize the debt by purchasing an unlimited amount of new sovereign debt issued. As long as the Central Bank can maintain credibility the charade can last an indefinite amount of time. I am of the camp that economic fundamentals can be delayed for extended periods, but the laws of economics cannot be repealed. If country running large fiscal deficits does not make changes, the negative effects of over indebtedness will surface with a vengeance.

Clint Pekrul, CFA: That's a timely question, given that the deficit has swelled from roughly $650 billion in 2017, the year president Trump took office, to approximately $980 billion today. That's a jump of about 50%. Former Fed chairman Alan Greenspan spoke recently that the ballooning deficits will ultimately lead to inflation. As excess dollars float through the system, overall price levels will tend to rise. This view suggests there is a direct link between burgeoning deficits and resulting inflation. We generally understand what policy action the Fed would take to tame inflation – an increase in policy interest rates. As we saw in 2018, even the prospect of higher interest rates is very disruptive and tends to rattle investor confidence.

We've been talking about higher inflation and higher interest rates for over a decade now. First, the narrative was that with all the quantitative easing (i.e. money printing) that followed the credit crisis, inflation was sure to follow. Expanding the currency base would push prices higher. However, this didn't happen. Banks did not loan out the money and the money supply didn't flood the market (i.e. no inflation). Now the narrative is that with record deficits (as a percentage of GDP), we're sure to trigger inflation. But it depends on how we finance these deficits. If there is global demand for Treasuries, as there is today, then the government can keep financing by issuing debt securities. I think the biggest risk for inflation is if for some reason markets perceive a deterioration in the credit risk of U.S. debt securities. In that case the demand for U.S. treasuries will wane, and rates will rise. To combat this, the Fed might be forced to print our way out (i.e. basically make worthless money). Then we will have an inflation problem.