Inflation Concerns? A Monetary and a Policy Perspective

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The Case for Inflation, a Monetary Perspective

I am repeatedly asked about the possibility of inflation. While inflation is currently at very modest levels, I think there is little doubt that a more serious level of inflation is a genuine possibility. Let's understand why from a monetary perspective.

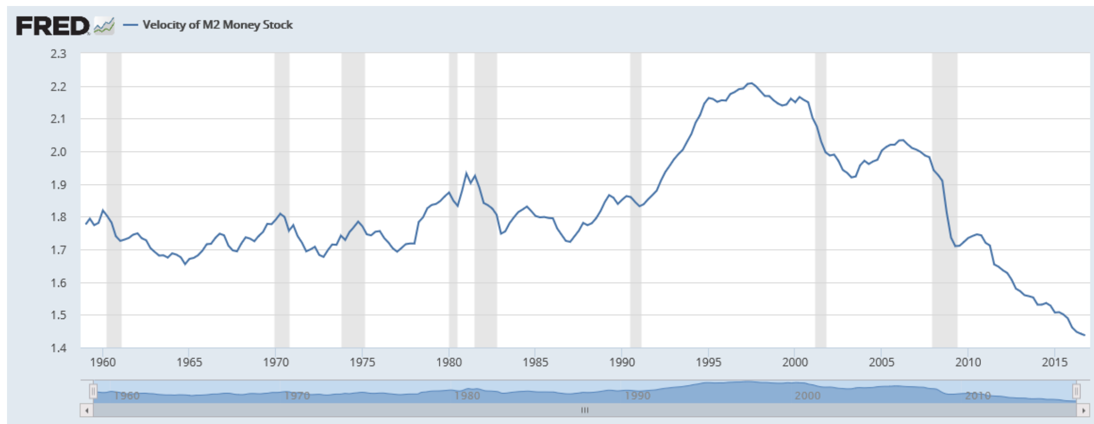
First, inflation is defined as, "A sustained, rapid increase in prices, as measured by some broad index over months or years and mirrored in the corresponding decrease in purchasing power of the currency.[1]" The Federal Reserve focuses on the "price inflation measure for Personal Consumption Expenditures (PCE) produced by the Department of Commerce, largely because the PCE index covers a wide range of household spending[2]." But what would cause this "rapid increase in prices?" Monetarists, economist that believe that fluctuations in the levels of the supply of money drive fluctuations in real economic output and is the major cause of inflation, rely on the Equation of Exchange to explain this phenomenon. That is, the money stock (m) multiplied by the velocity (v) of the dollar[3], is equal to price (P) multiplied by productive output (Q).

$$m \cdot v = P \cdot Q$$

Let's work backwards through this equation. Q, productive output, is very difficult to change. Productive output changes as result of rising overall levels of education and the introduction of new

[1] http://www.businessdictionary.com/definition/inflation.html
[2] Board of Governors of the Federal Reserve System (https://www.federalreserve.gov/faqs/economy_14419.htm)
[3] Velocity of the dollar is number of times that money turns over (spent) in a given year. That is, the number of times one unit of money is spent to buy goods and services per unit of time. This is defined as GDP divided by the money supply.

technologies that increase work efficiencies. These types of technologies take time to gain widespread adoption and understanding and therefore changes incrementally. It takes time for new technologies and learning to be absorbed into a large populace and for that populace to "lever up" gross productivity. Therefore, productive output changes at a relatively glacial pace, leaving price (P) to be highly "sensitive." On the other side of the equation is money stock multiplied by velocity. During the past 9 years, the United States government has added an enormous amount to the money supply[4]. Further, the governments of Europe and Japan have "piled on" pushing up the global money stock to historically high levels[5]. Normally, price would correspondingly have been affected to the upside. That is, inflation. However, the velocity of money has negated much of the effect of increase supply of the money stock. The velocity of money (recently) has been, and remains, at historic low levels. Please see the chart below.



Source: Federal Reserve Bank of St. Louis (6 April 2017)
Shaded areas indicate U.S. recessions

Since the money added to the "system" cannot be taken back, we would reasonably expect that once the velocity of the dollar "mean reverts" (returns to its average) that there will, and must be, an increased probability of inflation.

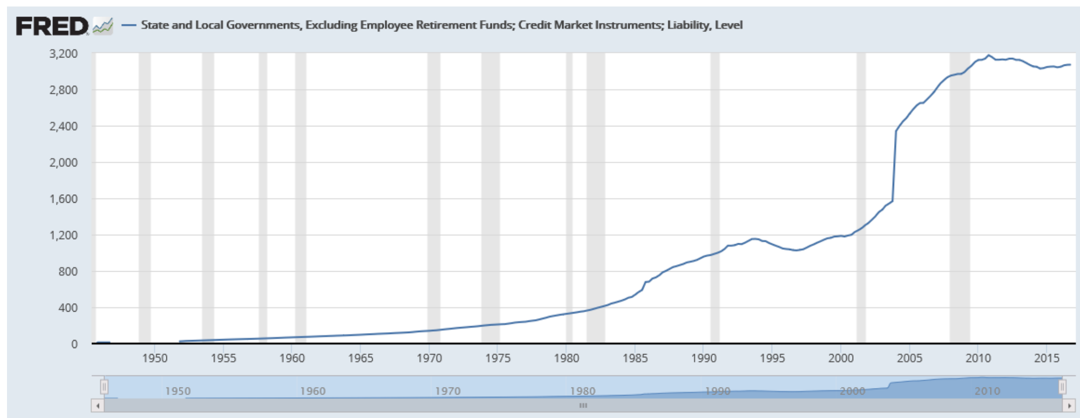
The Case for Inflation, a Policy Perspective

[4] http://money.cnn.com/2016/09/08/news/economy/central-banks-printed-nine-trillion/
[5] IBID

It is the stated policy of the Board of Governors of the Federal Reserve System to maintain an annual inflation rate of 2 percent.

> "The Federal Open Market Committee (FOMC) judges that inflation at the rate of 2 percent (as measured by the annual change in the price index for personal consumption expenditures, or PCE) is most consistent over the longer run with the Federal Reserve's mandate for price stability and maximum employment. Over time, a higher inflation rate would reduce the public's ability to make accurate longer-term economic and financial decisions. On the other hand, a lower inflation rate would be associated with an elevated probability of falling into deflation, which means prices and perhaps wages, on average, are falling--a phenomenon associated with very weak economic conditions. Having at least a small level of inflation makes it less likely that the economy will experience harmful deflation if economic conditions weaken. The FOMC implements monetary policy to help maintain an inflation rate of 2 percent over the medium term.[6]

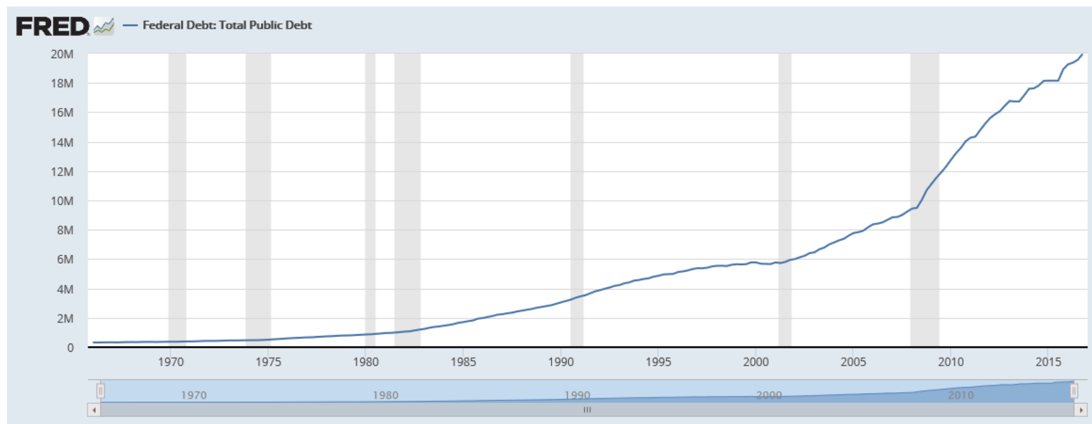
According to Federal Reserve Bank of St. Louis the State and Local Government Debt, excluding employee retirement funds, credit markets instruments stands at 3.072 trillion dollars. Please see the chart below.



Source: Federal Reserve Bank of St. Louis (6 April 2017)
Shaded areas indicate U.S. recessions

Further, according to Federal Reserve Bank of St. Louis the Federal Debt, stands at 19.977 trillion dollars. Please see the chart below.

[6] Board of Governors of the Federal Reserve System (https://www.federalreserve.gov/faqs/economy_14400.htm)



Source: Federal Reserve Bank of St. Louis (6 April 2017)
Shaded areas indicate U.S. recessions

The combined balances of federal and state and local debt easily exceeds 20 trillion dollars. There are essentially 4 ways to deal with this debt.

The first way is the pay it off and this is highly unlikely. Politicians have never shown any constraint to live within a budget and reduce debt.

The second way is to simply default and not pay the debt nor the interest on the debt. The consequences of default are such that this is really no option at all.

The third way is grow the economy faster than the increase of the debt so that the amount of debt relative to the economy is of little consequence. The federal government proposed budget for 2017 is 3.69 trillion dollars with a projected deficit of 443 billion dollars (or 2.6% of GDP)[7]. In order for there to be a significant change in the relationship between the federal debt and GDP there would have to be both a significant decrease in spending along with hyper-growth of the economy. In my opinion, both are unlikely to happen.

The fourth and final way to deal with debt to make it worthless in real terms. That is, allow the corrosive effects of inflation to devalue, in real terms, the debt. Inflate it away.

[7] Inside Gov. http://federal-budget.insidegov.com/l/120/2017-Estimate

Conclusion

Despite the stated policy of the US to maintain a target annual inflation rate of 2%, in the end, there may be little choice in the matter as the federal, along with state and local debt are reaching levels that are unsustainable. Further, from a monetary perspective, all the "pieces" are in place for creating a highly inflationary period in the near term.

About the Author:

Joseph J. Klauzar is a First Vice and Founder of President of Chartwell AMG of Raymond James in Los Angeles. Prior to joining Raymond James & Associates, Joseph was Vice President, Portfolio Manager, Family Wealth Advisor and Financial Advisor at Morgan Stanley. Joseph has over 25 years of global investment management experience both within the United States and internationally.

Joseph graduated for the University of California at Berkeley (BA/BA) in Asian Studies and East Asian Languages (Dual Majors). Joseph earned his Master of Real Estate Development (MRED) degree from the University of Southern California, the Lusk Center for Real Estate at the School of Urban and Regional Planning. Joseph earned his Master of Business Administration (MBA) from Northwestern University, The J. L. Kellogg Graduate School of Management. Joseph completed post-graduate programs in investment analysis and alternative investments at the Wharton School at the University of Pennsylvania.

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