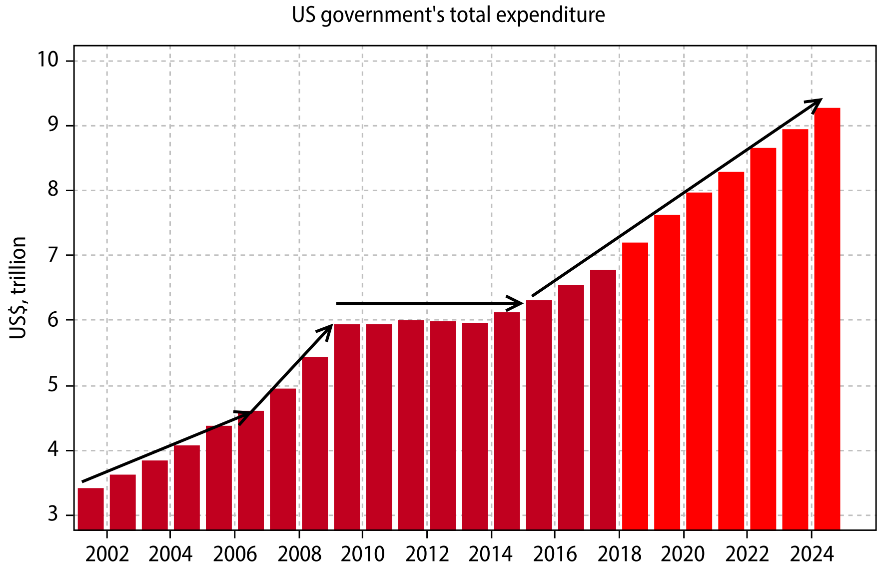
The Case Of The Missing Inflation: US Fiscal Policy

Louis-Vincent Gave
lgave@gavekal.com

The French economist Jacques Rueff famously said that inflation consists of funding "expenditures that give no returns with money that does not exist". With this in mind, consider the chart below.

Exploding deficits



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There is a well worn path of certain US political configurations creating particular fiscal outcomes...

While US government spending rose sharply in the first two years of President Barrack Obama's term (due to the 2008 crisis and a "shovel-ready" stimulus bill), the election of Tea Party Republicans in 2010 caused spending to basically flatline for the rest of the Obama years. To put this in context, the public spending habits at work in the US can be described as follows:

- Democratism: to increase government spending.
- Keynesianism: to increase government spending when the economy is slowing and reduce it when the economy is expanding.
- Republicanism: to raise government spending when a Republican is in the White House and reduce it when a Democrat is in the White House.

...spending has tended to be restrained when there was a Democratic president and a Republican congress

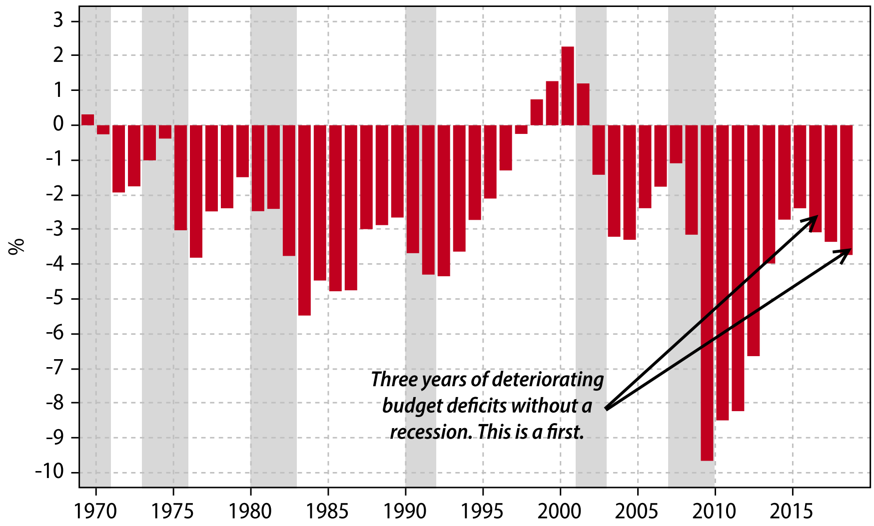
Thus, to contain government spending (and so, according to Rueff, avoid inflation and debasement) the only positive electoral outcome tends to be a Democratic president with a Republican-run Congress. This was the set-up in the late 1990s and in 2010-16, and inflation duly fell in these periods.

Such a political configuration no longer rules and in recent years an odd pattern has emerged: the US economy has performed at the high end of expectations, with record low unemployment and strongly performing asset markets, yet, budget deficits have widened sharply. This upends the historical pattern whereby deficits shrink during growth phases and rise in recessions.

US deficits have dramatically expanded since 2016, despite the economy having been strong

The US budget deficit has expanded even without a recession

US budget deficit as a percentage of GDP | Shaded grey: US recessions



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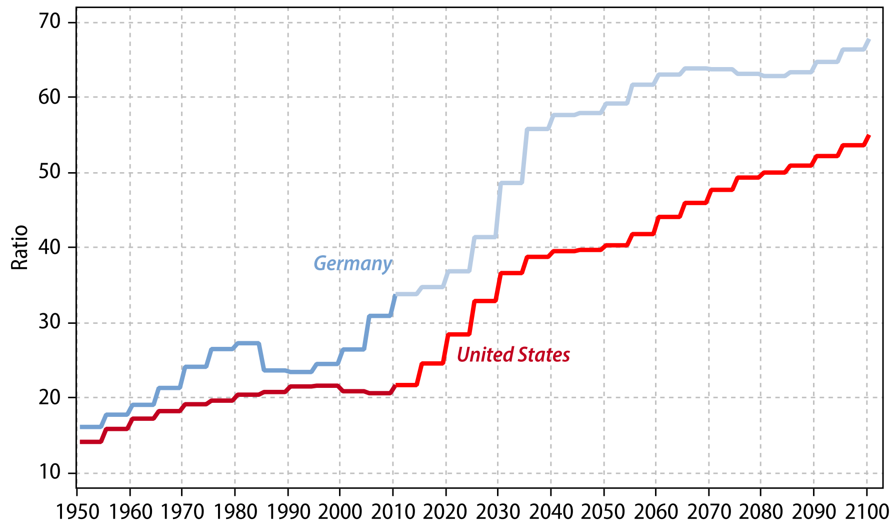
The reason for this breakdown is simple: the US is now aging. While the old-age dependency ratio (the ratio of people over 65 years old to those working) had broadly flatlined at about 20% for 40 years, it is now rising fast.

Demographic pattens in the US point to a significant structural rise in public spending in the coming years

The US's old-age dependency ratio is rising

Ratio of population aged 65+ per 100 population aged 20-64



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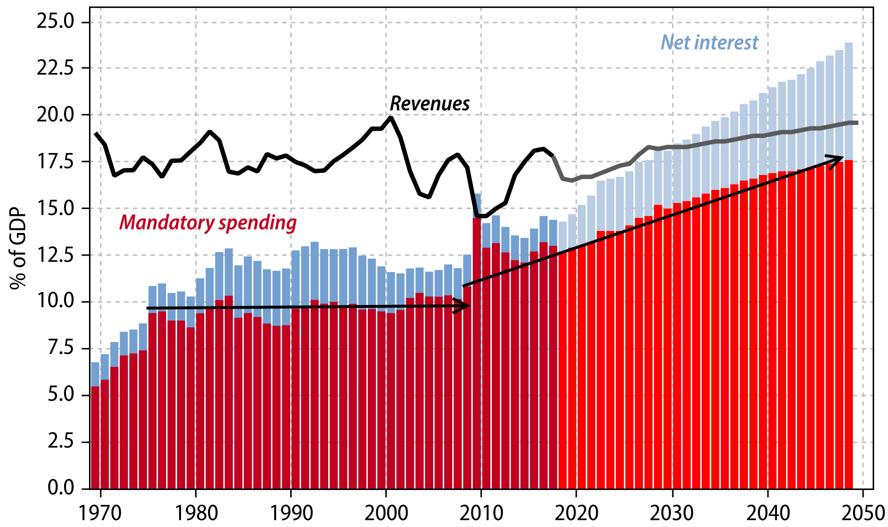
And as America ages, mandatory spending on social security, Medicare and Medicaid will rocket higher. For years, that spending remained below 10% of GDP. Today, it stands at 12%, and in the coming decade, as the chart overleaf shows, it is set to head relentlessly upward to 17%.

Mandatory spending and interest payments will exceed projected US government revenues in and around 2030

Interest and mandatory spending will overwhelm revenue around 2030

The Congressional Budget Office's projections of government incomes and outlays



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How will this increase be funded?

US Policymakers will face the following options:

1) Cut services and transfers to the greying population. Given the propensity of this group to vote in most Western democracies, such an approach does seem unlikely. In contrast, in most non-Western countries such as China, Russia and India, older folks have been promised very little, which is pretty much what they will get!

US policymakers face a range of choices as they face up to a tough fiscal situation

2) Increase taxes on the private sector to pay for the social transfers. This is possible in the US and is becoming the Democratic Party's platform. In the likes of France, Italy and the UK, higher taxes are a non-starter and may spark an open revolt. Either way, taking money from a productive private sector for use in non-productive social transfers would guarantee lower growth and inflation. This scenario would be very bond-bullish.

3) Continue to borrow more money from a productive private sector for deployment into unproductive social transfers, thereby also guaranteeing a weak economic growth environment. This option may still be open for now, but could a shifting demographic landscape tip the scales?

4) Double down on the actions of governments in the US, Europe and Japan by having central banks print money and then buy up government debt—or as Rueff put it "fund expenditures that give no returns with money that does that does not exist".

The lack of willingness to accept hard choices explains the current interest in Modern Monetary Theory

Facing the above four options, political leaders everywhere, but especially in the US, are showing morals loose enough to ensure disapprobation in a farm yard. There is no willingness at all among the Washington DC elite to tackle underlying issues behind the growing funding gaps. The latest idea—Modern Monetary Theory—is just an attempt to offer Scandinavian levels of government services without Scandinavian levels of taxation (see **Not Modern, Not About Money, And Not Really Much Of A Theory**).

Investors will need to start focusing on the possibility of there being a left-wing economic radical in the White House...

Which brings us to the US presidential primary season. With 20 candidates vying to take on President Donald Trump in 2020, the Democratic party is offering voters anything from unrepentant socialists who honeymooned in the Soviet Union, to the more usual centrist fare. Investors have not really begun to worry, or price in, the chances of a Bernie Sanders, Elizabeth Warren, or Kamala Harris presidency. But imagine that Senator Sanders does win the nomination (he nearly got it in 2016 and is starting this time with more money and a database of committed volunteers). Crazier things have happened: the leader of her Majesty's opposition in the UK is, after all, an unrepentant Trotskyite (no, not our very own Anatole, but Jeremy Corbyn!).

...this is unlikely to be a bullish situation for the US dollar...

If Sanders and Trump do face-off next November, investors will have to assume that the election is a coin toss, even if polls give Trump an advantage. After all, polls gave Hillary Clinton a clear edge in 2016, and what good were those? It is likely that the threat of a significant "tax and spend" agenda will make both rich Americans, and foreigners exposed to US assets, think twice about their asset allocations (see **How Contagious Is The Health Care Downturn?**). As Europeans have often done when confronting the prospect of socialist parties taking power, Americans are likely to get into the business of hiding wealth. Simply put, the threat of Sanders, Warren or Harris becoming president is unlikely to be bullish for the US dollar.

...then again, a second Trump term may not be dollar-bullish either

But what of the US dollar in the event that Trump secures a second term? He has hardly advocated a "strong dollar" policy, and nor is he a proponent of restrained spending. Last year, the US Treasury increased its debt issuance by US$1.34trn, roughly equal to one year's worth of Spanish GDP; this year, that issuance is expected to hit US$1.4trn. Over the next ten years—assuming 3% economic growth and no recession—the US government will have to borrow an extra US$12trn. That is about the same as the combined GDP of Japan, Germany and France for a year. The question is: where will such sums be found?

Will the US$12trn be found between the cushions of the Treasury's couch? If not, will foreigners continue to happily recycle their excess savings into US treasury securities? If the answer to those questions is "no" the odds are that it will be created out of thin air…