We Could Use Some Inflation

By Kerry Pechter *Thu, May 7, 2020*

The Treasury said this week that it will borrow (and spend) about $3 trillion this quarter, to cover its stimulus promises. Where does that money come from and where does it go? 'The capital is going from one pocket to another,' explains Vanguard's active Treasury fund manager, who expects the stimulus to be withdrawn in 2022.

My bank's small business loan officer called me yesterday. In normal times, the bank calls only when a fraudster in Texas or the Ukraine abuses my debit card number. But this time, she just wanted to chat. So I asked her about the Paycheck Protection Program (PPP).

Our small community bank has made about 9,000 PPP loans so far, she said. Then she asked if I'd like to borrow up to 10 weeks of income, forgivable if spent on payroll. It didn't matter that I was self-employed and would just pay myself. She emailed me a loan application.

A lot of Benjamins are in motion. On Monday, the U.S. Treasury announced that it would borrow $2.999 trillion in the current quarter and another $677 billion in the fall. Even in wartime, the Treasury has never borrowed more than $1.8 trillion in a year.

There are several ways to think about this money. It's not like the old, indestructible, intrinsically valuable money, like the 1921 'Walking Liberty' silver dollars I collected. Like gold itself, this commodity money feels reassuring in the hand. It's also the easiest to remove from circulation.

The country's money is also a creature of credit. It appears when governments spend and banks lend. It disappears when taxes are collected and loans are repaid. It can be fickle too: A market correction can erase half of a country's savings overnight—and put a billion dollars in one short-seller's pocket.

The kind of money that the federal government will create this quarter may be the hardest to get your mind around. When private spending slows, the Fed and Treasury fill the hole by borrowing against future tax receipts. As long as the future is infinitely long and the U.S. infinitely rich, our pockets are infinitely deep.

Where does $3 trillion come from?

When I heard that Treasury would borrow almost $3 trillion this quarter, I admit that the floor trembled a little under my feet. So I emailed a laconic macroeconomist I know and asked him, Who will buy all those bonds? “Everyone,” he replied. Would all that borrowing-and-spending cause inflation, I asked. “No,” he wrote.

Hoping for more information, I called Vanguard and talked to Gemma Wright-Casparius, who manages Vanguard’s active Treasury and inflation-linked (TIPS) bond funds. “It’s a big circular handoff,” she explained.

Asset managers like Vanguard, pension funds, life insurance companies, foreign central banks and individuals buy Treasuries to fund government expenditures. The expenditures become deposits (liabilities) in U.S. banks, which need to add cash reserves for them. The Fed furnishes those reserves by buying Treasuries from the banks. “The capital is going from one pocket to another,” she told me.

In theory, the Fed could buy IOUs directly from the Treasury, and leave the private sector out of the loop. But then money wouldn’t circulate through the financial system and the private economy would stop. That still leaves the question of inflation: Won’t an infusion of $4 trillion or $5 trillion this year into a $22 trillion economy drive up prices?

Not if it replaces money that’s gone. Wright-Casparius said that the 2020 stimulus, despite its size, won’t be immediately inflationary because it’s filling a vacuum—the financial crevasse that suddenly opened up in the U.S. economy when 20-odd million people stopped earning money and paying bills in April.

“In the long run, when economies are fully reopened, you could get a synchronized resurgence of global growth,” she added. “Depending on how long policy makers leave the stimulus in the system, it might be inflationary. “But the Treasury is only borrowing money for a limited period of time. By 2022, projections indicate they’re planning to unwind the stimulus.” (It’s not clear exactly how the training wheels will be removed.)

Then I reached out to Barry Eichengreen, a macroeconomist at the University of California at Berkeley and author of ***How Global Currencies Work*** (Princeton, 2017) and other books about money. I asked him where the Treasury could get so much money so fast.

“If you are asking, ‘Where will the Treasury get the money to run a $5 trillion deficit this year?’ the answer goes as follows: It will sell bonds.” To make sure an over-supply of

Treasuries doesn't drive down their prices and raise interest rates, "the Fed has a program in place to prevent 'disorderly conditions' in Treasury bond markets," he said. That is, the Fed will step in as a buyer.

"So the question then becomes: Is this money-printing inflationary? Does the Treasury effectively 'get the money' by running inflation (what economists would refer to as 'imposing an inflation tax')? There is much debate about this at the moment among macroeconomists," he continued.

"I would caution against mindlessly succumbing to the instinctual reaction that 'money-printing is always and everywhere inflationary,'" he wrote. "Some macroeconomists warned that the Fed's extraordinary actions starting in 2008-9 would cause an explosion of inflation, and they were wrong. The Fed has consistently been unable to get inflation up to its modest 2% target despite the unprecedented peacetime expansion of its balance sheet from 2008 to 2019."

Why doesn't the extra money cause inflation? "After a crisis, households 'deleverage' (they save rather than spend)," he said. "Firms are cautious about committing to ambitious fixed investment plans in the presence of uncertainty about the nature of the post-crisis environment. So the money the Fed creates (the cash it 'prints') mainly sits idle in individual and corporate savings accounts (and in retirement savings accounts). Whether and for how long this will continue is the question that is being debated."

Tax increases versus inflation

Googling for more information about Treasury sales and inflation, I found articles by Chris Brightman, the partner of Rob Arnott at Research Affiliates, Olivier Blanchard of the Peterson Institute for International Economics, and Tim Duy, a University of Oregon economist who writes the **FedWatch** blog.

Brightman was the most inflation-wary of anyone I heard from. "Some combination of tax increases and spending cuts following the coming recovery will become necessary to prevent a spike of inflation," he **wrote** recently. "Will Congress understand precisely when to execute this fiscal U-turn? Will our politicians display the required foresight and courage? I worry. A future bout of high and volatile inflation may prove to be a toxic side effect of today's experimental economic medicine."

But Olivier Blanchard forecasts only a 3% risk of inflation. "One may still worry that, when social distancing is relaxed, pent-up demand will lead to a burst in spending, and some inflation. If it happens, it is unlikely to be large and long enough to destabilize inflation expectations, and it is likely to disappear quickly," he **writes**.

Tim Duy agrees that deflation is the bigger threat. "It was common early in the crisis to view the viral outbreak as a supply shock because, from the U.S. perspective, it appeared to be largely impacting the flow of goods from China. This original view suggested an inflationary impact from the virus," he **wrote** at Bloomberg Opinion last week.

"The demand-side impact, however, now clearly dominates the economic outlook. Shutting large portions of the economy resulted in a collapse in spending and surging unemployment," Duy observed. "Yes, in comparison to the dismal second-quarter numbers, the third quarter will likely bounce as some activity returns. This bounce, however, will not be sufficient to lessen the gaping hole in demand left by the virus."

As for myself, I haven't decided whether or not to apply for that PPP loan from my bank. I hesitate to borrow—no matter how "forgivable" they say the debt will be. But if this crisis lasts long enough, I might wish I had.