Harry's Take

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The Difference Between Monetary and Fiscal Stimulus: Inflation in Financial Assets vs. the Consumer Price Index

A lot of forecasters were expecting inflation to rise substantially from the unprecedented money printing in the wake of the 2008 financial crisis. Inflation didn't really rise after $3.6T was printed between early 2009 and 2014. After that, the Fed kept their balance sheet at a plateau into 2017 before tapering it a bit into 2018, but then they had to reverse their actions when the economy didn't respond well. But there still was no major effect on inflation, either up or down.

Then, a new, stronger surge in stimulus was used to fight COVID, a short-term pandemic. Now, inflation suddenly has surged, from 0.4% in 2020 to 8.5% as of March 2022. Inflation backed off slightly to 8.3% in April, and we're about to see if it stays stubbornly high into May as expected, once the June 10 Consumer Price Index (CPI) report hits.

There is a reason that consumer price inflation has surged dramatically since 2020. The stimulus into 2014 and beyond was largely monetary… The Fed was printing money and buying financial assets (government bonds) with it. The stimulus plan since 2020 not only has been massively larger, at $10T in just over two years, but included both $5.1T in fiscal and $5.0 in monetary stimulus… There's the rub. The first $3.6T in monetary stimulus came with a more-minor $800B in fiscal stimulus, or 18% of the $4.4T of combined stimulus. In the more-recent plan, the split between monetary and fiscal stimulus was 50/50.

It has been the stronger fiscal stimulus this time that has been most responsible for causing a strong, sudden inflationary surge on the CPI to 8.5%, the highest it's been since the near-15% peak in 1980. Monetary stimulus goes mostly into financial asset inflation. Fiscal stimulus goes directly into CPI inflation.

Monetary stimulus is executed when central banks buy Treasury or agency bonds, financial assets that will then go up in price and down in interest yields. But, more importantly, that adds new money into the whole financial asset pool beyond the natural savings of consumers and businesses—and that new money increasingly tends to flow toward the highest-yielding assets in such areas as stocks, junk bonds, and real estate. **Monetary inflation largely inflates financial assets**… and that makes people feel richer. Once that happens, people tend to spend a small portion of their increased assets near term but save the rest.

Today, fiscal stimulus largely is given to states, consumers, and businesses to spend. Of the $5.1T in fiscal stimulus issued since 2020, about 80% already has been spent. The rest should hit over the next year or so. That money is going into demand at a time when natural supply constraints from COVID are still in play. **Fiscal stimulus largely creates consumer price inflation.**

The difference between these two types of stimuli along with the much-greater weighting toward fiscal stimulus since 2020 explain why we experienced substantial financial asset inflation until 2020 with no noticeable impact on consumer price inflation and why only recently have we been experiencing a strong surge of consumer price inflation: again, from 0.4% in early 2020 to 8.5% in early 2022.

And that means it's "game over" for the central banks, as sharply rising inflation will force them not only to stop monetary inflation, but also to tighten interest rates and reduce their balance sheet to slow the inflation created by fiscal stimulus.

My view, based on my understanding of the very-weak underlying demographic trends in the U.S. (which will continue through 2022–2023) is that the economy will react very poorly to the withdrawal of this unprecedented stimulus… just like a heroin addict would in detox! We very likely will be in a deep recession by year-end.

Harry

Got a question or comment? You can contact us at info@hsdent.com.