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Analysis of today
Assessment of tomorrow

By: Daniel Lacalle

Fighting inflation requires a sound fiscal policy

Governments have no interest in reducing inflation because they benefit from it. With inflation, tax receipts rise as most economies do not adjust taxation to the consumer price index, and public debt seems to decline even though it rises in absolute terms. The ratio of public debt to GDP is "reduced" thanks to inflation bloating nominal GDP.

Our current inflation burst has been triggered by the massive increase in money supply of 2020-21.

Borio's study for the Bank of International Settlements, or the studies of Hanke, Congdon and Castañeda, shows that the inflationary episode came from the abrupt increase in the quantity of money. Even Summers and Furman warned of the inflationary risk.

Why wasn't there inflation between 2008 and 2019 when monetary policy was extremely loose as well?

First, there was. Real estate prices soared, prices of non-replaceable goods rose to all-time highs including food and shelter, financial assets reached historic highs drive by multiple expansion. Inflation is not just CPI.

What differentiated 2020-21 from other monetary expansion episodes is that the injection of artificially created new currency was more than five times higher than what we called "extraordinary" in 2009-2014.

All that newly created currency, instead of staying in financial assets, was used to propel public spending. And that is why, among other things, inflation in the eurozone is much higher than that in Switzerland, with the same external risk factors, or that of South Korea or China.

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Keynesian consensus was silent about the aberration of negative rates and uncontrolled monetary expansion, and now we face the consequences.

Most governments never do anything to combat inflation, they just find creative ways to blame anyone and everyone except public monetary and fiscal policy. That is why inflation is called a hidden tax.

Neither corporate profits, nor wages, nor freights generate an increase in aggregate prices in a sustained and continuous manner.

All these elements may explain the variation in unit prices but do not explain a constant increase in aggregate prices.

The only thing that makes aggregate prices rise constantly and consolidate the previous year's increase annually is the destruction of the purchasing power of the issued currency.

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To combat inflation, policymakers must do three things: Raise interest rates to at least a neutral level that matches long-term inflation expectations, reduce the amount of money in circulation in the system and reduce public spending, especially those elevated deficits that involve increased consumption of new currency units in the future.

The big problem of these past months is that there has been a false narrative of optimism with inflation.

Firstly, because it deceives citizens by making them think that a reduction in the annual consumer price index (CPI) rate is a decline in prices. Prices have risen in aggregate almost every month between January and August.

Governments say that inflation is falling, but do not explain that it is because the interannual rate starts from an exceedingly high base level. Accumulated inflation in the U.S. since 2019 exceeds the 18% level.

Governments and financial analysts have declared the end of the inflation problem due to a moderation that comes mainly from the base effect - the year-on-year rate is compared to a very high figure - and due to the fall in commodities thanks to rate increases.

However, the decline in commodities has changed trend since May when monetary easing began to be announced, and the effects of supply and demand are moving the price again.

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We would not have such a high level of headline and core inflation, the latter tripling the objective of the Fed and the ECB, if a genuine normalization of monetary and fiscal policy were to be carried out.

We must not forget that the ECB's balance sheet represents 52% of the eurozone's GDP compared to 31% of US Federal Reserve GDP, that eurozone citizens have suffered for years from the economic aberration of negative interest rates and that states have consolidated and in some cases increased the consumption of new monetary units with the Next Generation Europe funds and high deficit where many governments present themselves as the solution to the inflation they have created by consuming even more newly issued currency units.

The U.S. deficit is expected to reach $2 trillion per annum and $14 trillion accumulated to 2030 in the administration's estimates. That means more inflation and more taxes in the future.

We need a responsible fiscal policy that eliminates the incentive to borrow and increase inflation, impoverishing citizens.