Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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Only a pro-growth and government spending-cut plan will curb inflation

Inflation is a hidden tax. Governments create inflation by diminishing the purchasing value of the currency they issue through enormous debt and deficit spending and benefit from the decline in value because the public financial obligations dissolve in real terms. On the flipside, your wages and deposit savings are worth less.

The latest reading indicates that the battle against inflation remains far from over, and one could even argue that it never truly began.

The September Personal Consumption Expenditures Index (PCE) surprised some market participants with an increase of +0.2% over the previous month, primarily due to the core PCE rising faster than expected at +0.3%. What does this mean?

Core inflation, which excludes energy and food and is less volatile, has reached an annualized rate of +2.7%, showing no signs of disinflation since May.

Core annualized PCE inflation was +2.6% in June and months after the alleged positive trend signaled by the Federal Reserve, it remains at +2.7%.

The Federal Reserve has declared victory against inflation with an accumulated 20.4% rise in aggregate prices in the past four years. I would not call that a victory.

Furthermore, the entire decline in the headline PCE Index since May has been caused by the slump in the volatile energy component due to the fall in commodity prices in international markets.

The euro area inflation

In the euro area, market participants talked about a “surprise” negative reading in headline harmonized inflation, which rose to 2.0% from 1.7% in the previous month. This aligns with the accumulated inflation of 20% over the past four years.

However, the euro area inflation also presented a couple of significant negatives. The inflation rate for services remained at 3.9% annually, while the inflation rate for all items, excluding unprocessed food, increased to 3.0%. The energy component was the only real inflation item at -4.6%.

> The reality is consistent with persistent, not falling inflation

There are many reasons to justify these negative readings of inflation, which suggest that the reality is consistent with persistent, not falling inflation.

The first and most important factor is that the money supply has been increasing steadily in the past months, and inflation is always a monetary phenomenon.

The second relevant factor is that rate cuts have been announced too quickly, creating a floor on international commodities and halting the disinflation path.

The third relevant factor is the continued increase in debt by governments.

Global debt has soared to $100 trillion

The IMF warned that global debt has soared to $100 trillion and is likely to accelerate in the coming years. In the case of the United States, the Treasury expects an annual deficit of close to $1.8 trillion in the next ten years and almost $16 trillion of new debt, which means more printing of new units of currency and therefore an almost guaranteed outcome of erosion of the purchasing power of the US dollar.

The IMF is warning of the risk of market shocks due to the accumulation of public debt. Some signs are already evident.

United States bond yields are rising despite the Fed’s rate cut path because market participants fear that the future will be more printing and debt, fueling persistent inflation and the risk of stagflation.

> The euro area does not have an imminent solution

The euro area does not have an imminent solution. Governments in France or Spain are unwilling to curb spending and, as such, will continue to run on unsustainable structural deficits.

Misguided neo-Keynesian policies are setting the roots of the next government debt crisis in the euro area despite ultra-dovish ECB policies.

In the United States, there are two alternatives. More government spending or lower taxes.

The world of upside-down economics

More government spending is inflationary because it means more new units of currency issued. Cutting taxes is not inflationary because it is the same units of currency, only giving more to the ones that earn it.

Many economists fear that tariff increases will drive inflation higher. That is simply not understanding money. Tariffs suggest an increase in US dollar purchases, but they do not necessarily lead to a rise in aggregate prices.

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Tariffs added to a reduction in excessive government spending have not driven inflation higher ever in history. However, government spending and printing currency above private sector demand have always fueled inflation.

Investors correctly fear more printing and stagflation risk in the future unless the next administration implements a true pro-growth and spending cut plan, which is why markets ignore the Fed's dovish messages and rate cut path.

Unfortunately, the Federal Reserve will cut rates by 25 basis points in the next meeting to try to bail out the Treasury’s insolvency while the government perpetuates inflation by overspending and printing.

We are living in the world of upside-down economics, where governments bloat GDP, increasing debt and investment decelerates, and where policy is aimed at perpetuating public excess instead of incentivizing private growth.

If we want disinflation, we need to understand that it will only come from lower spending and curbing money printing.