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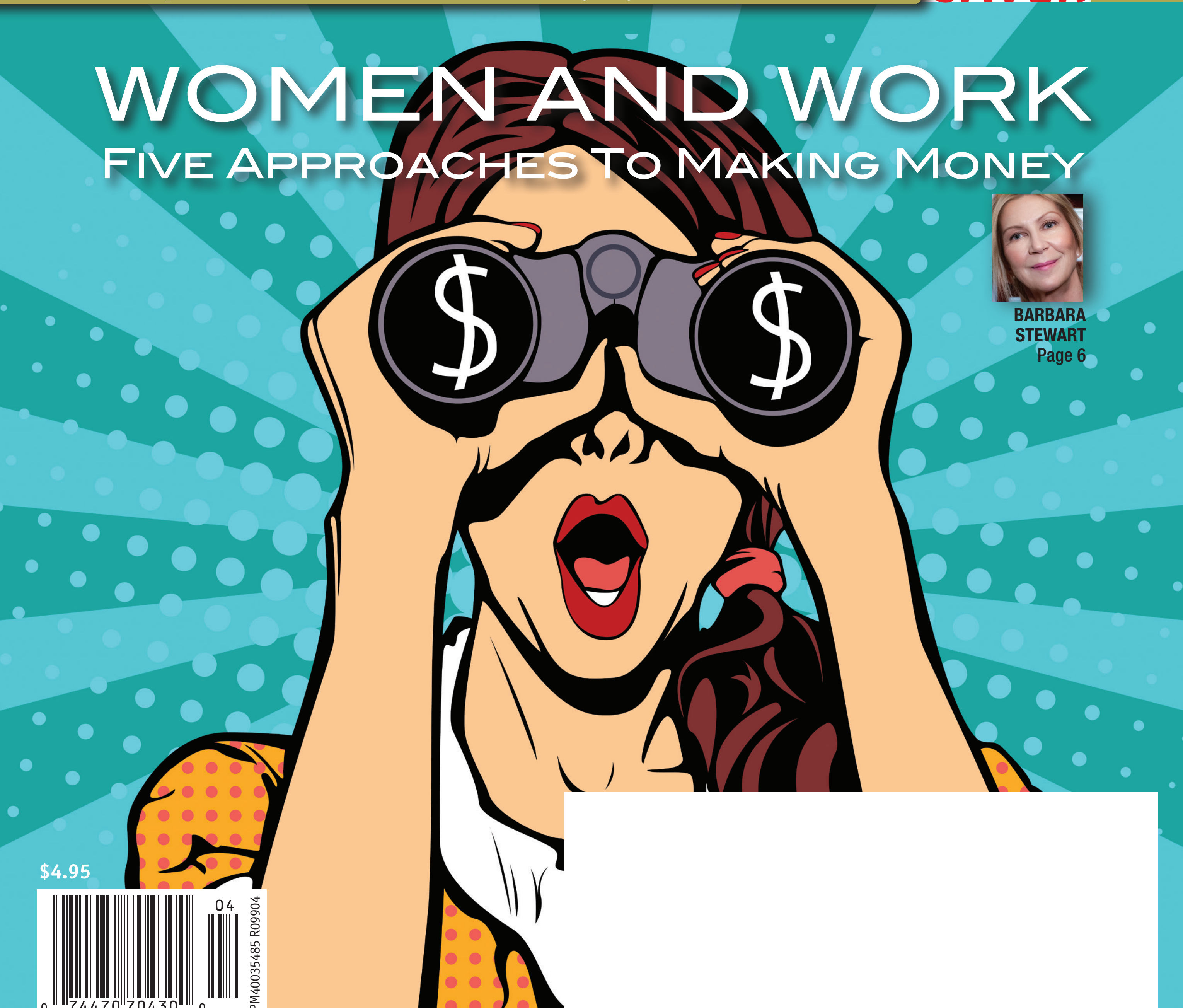

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How Governments Cause Inflation

Brian Chang

Many people today believe that the creation of money "out of thin air" by central banks is one of the primary causes of the rapid acceleration of prices that occurred in the aftermath of the COVID-19 pandemic. While this view makes intuitive sense, the creation of new money by central banks does not generally result in higher inflation —government deficit spending does. Of course, to the casual observer this may seem absurd. The monetary policy response undertaken in response to the COVID pandemic has resulted in a tidal wave of new money being created in private sector bank accounts. Given that no new goods and services were created because of these operations, and given that inflation is often defined as "too much money chasing too few goods", how is it that this money is not inflationary in nature?

By contrast, using this same logic, debt-financed fiscal deficits by governments should be non-inflationary in nature. After all, deficit spending merely borrows money from existing entities in the private sector and re-distributes these funds to other entities in the private sector. Under this type of a fiscal response, no new money is actually being injected into the system. The currency is clearly not being debased by the monetary authorities since no new currency or bank deposits are being created as part of the operation. Certainly, it must be the case that fiscal policy of this type is non-inflationary in nature, must it not?

The key to understanding the present dynamic is to realize that what drives inflation is not the quantity of money in circulation per se, but an increase in spending relative to the amount of goods and services in the economy. In order to illustrate the different ways in which both monetary policy (ie. "printing money" by central banks) and fiscal policy (ie. deficit spending by governments) impact general prices, we will provide hypothetical examples of an economic stimulus package of $10 billion injected by the central bank versus a $10 billion debt-financed fiscal injection by the government. We will then describe how each impacts general prices differently. Note that the topic of inflation is an incredibly complex topic. This article provides only a simple framework for the purpose of general understanding.

When governments choose to deficit-spend, the result is inflationary in nature, regardless of the fact that it does not increase the broad money supply. Consider first the mechanism by which governments deficit-spend using traditional debt-financing. The government issues a bond which is first purchased by the private sector, and then spends or transfers the proceeds from the bond sale to some other entity in the private sector by means of stimulus. The first thing to note is that the private sector lender, who previously had $10B in cash, now has $10B in bonds. Their net worth has remained unchanged. The government, after sending out the stimulus checks, is now left with a net $10B liability in the sense that they now owe $10B to the lender. They have a net increase in debt of $10B. The stimulus recipient, on the other hand, has now increased their assets by $10B in the sense that they were simply given an additional $10B to spend that they previously did not have.

If we follow the flow of funds carefully, we can see that while the government has gone into debt by $10B, they have correspondingly increased private sector net wealth by $10B. The lender, who previously had $10B of money they did not intend to spend in the economy, was given a bond of equivalent value, while the stimulus recipient received $10B of new funds (with the option to spend some or all of these new stimulus funds on goods and services of their choosing). By increasing the net worth of the private sector, government deficit spending has increased the ability of the private sector to spend within the economy, regardless of what is happening with the money supply.

Hopefully, what is obvious from the above example is that it is not the absolute amount of money that people hold which impacts their ability to spend, but their overall level of wealth. The lender might now hold a $10B bond where they previously held $10B in cash, but they had no desire to spend the money they lent to the government. Otherwise, they would not have bought the bond in the first place. Likewise, if the lender's $10B bonds were now suddenly replaced with cash, it would be absurd to think that the lender would now rush to spend this sum of money within the economy simply because they have $10B in cash instead of $10B in bonds. If the lender holding the bond wishes to make a purchase, they would merely sell their bond for cash and proceed to spend the cash on goods and services. Substituting a highly liquid asset (cash) for another highly liquid asset (government bonds) makes little real-world difference to the lender's spending decisions.

The mistaken belief is that the total amount of money in the economy drives increased spending levels rather than the total amount of wealth. Many commentators erroneously believe that central bank money creation is the primary culprit of rising prices. Consider now an injection of $10B of newly-created money into the economy, but this time undertaken via central bank "Quantitative Easing" (QE) programs rather than through government deficit spending. When central banks engage in QE, they create new money and use it to purchase government bonds from other private investors. Where these investors had previously held government bonds, they now hold cash. However, it is important to remember that while the central bank created new money and injected it into the private sector, they did not significantly increase aggregate wealth within the private sector.

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What central bank money-creation has done is to replace an investor's safe and highly liquid asset (a government bond) with another highly safe and liquid asset (cash). It hasn't significantly altered the financial net worth within the system. As we have already described, net worth, not money, represents the capacity, although not necessarily the desire, to spend on goods and services. As has already been stated, if you have a bond, you might as well have cash since a bond can be readily sold and converted quickly to liquid cash for spending. Changing the composition of safe and highly liquid assets from bonds to cash is largely unimportant for the vast majority of savers in a practical sense.

This, of course, is not to say that central bank money-creation has had no effect on inflation. Since QE serves to raise the price of bonds, the seller of the bond will wind up with more cash than they would have otherwise had in the absence of QE. Logically, having more wealth on hand would leave the bond seller with increased spending power to serve as additional fuel for inflation. This, of course, is true and a point readily conceded. We would only point out that the amount of capital gains that will accrue to an investor is small in comparison to the original market value of the bond, which is almost always what critics refer to when they talk about central bank money-printing leading to high or runaway inflation. The criticism has generally not been that the small amount of capital gains from the bond sale will be used to drive spending and inflation, but that the entire sum of money created by the central bank will somehow wash over the economy while simultaneously raising prices across the board. Capital gains due to the sale of the bond to the central bank certainly are realized, but we should not exaggerate its follow-through impact on spending.

It should be recognized then that what impacts inflation on the demand side of the equation is the total level of spending power (i.e. wealth), and the willingness of society to spend that wealth. While the factors influencing the willingness of the private sector to spend are highly psychological and a matter for another day, government policy can certainly influence the absolute levels of private sector wealth via debt-financed fiscal spending. By taking on large quantities of debt, the government's objective is to aggressively drive economy-wide spending by transferring wealth from themselves to the private sector. Not everyone who receives government stimulus will go on to spend their newly acquired funds, of course. Still, even if only a portion of recipients does, the net effect can provide a significant tailwind to an economy mired in a large-scale economic decline.

Of course, the wealth infusion into the private sector clearly does not result in an immediate increase of actual goods and services within the economy. As a result of the stimulus, therefore, increased private sector spending might actually bid up prices of the existing stock of goods and services since spending power has increased while the total amount of goods to purchase has not. If the government's deficit-financed fiscal spending is too small, it will fail to offset the natural decline in spending and aggregate wealth that naturally occurs during a recession. In this case, prices might not increase at all. If the stimulus is too large, on the other hand, it will increase private sector spending and net wealth far above what was lost as a result of the contraction. In this case, inflation may correspondingly increase as the private sector suddenly seeks to unleash their newfound purchasing power into the economy all at once.

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