Inflation and Fiscal Policy

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Financial markets have had a negative pivot over the last two weeks and monetary policy seems to be the culprit. The cause seems to be the slight uptick in the most recent inflation metrics. Suddenly, the outlook for a lower fed funds rate has gone from six cuts this year to maybe one or two as interest rates beyond the Fed's control seem to be surging. The impact of this surprise has been a decline in stocks and bonds. Yet, the conversation in economic circles is about growth, not the prospects for a recession. The latest update on Fed policy is to maintain current levels of short-term interest rates until inflation comes under control i.e., falling to or below the targeted 2% level. Observers will be ultra-focused on every economic measure, especially unemployment, to see what the Fed's next move will be. As we have written about for the past few weeks, reactions to short-term changes in these measures could continue to trigger increased volatility in financial markets.

But the real question is: Can Fed policy and changes in interest rates drive inflation lower or is there another reason behind higher inflation? The ability to achieve the Fed's inflation target of 2% may be more a function of fiscal policy than monetary policy. Even though the Fed gets credit for using higher interest rates to lower inflation, such expectations may be misguided. All the Fed can do is change the target for short-term interest rates, they cannot impact supply and demand.

Inflation is defined as too much money chasing too few goods, which means that fiscal policy can play a much more important role in determining the level of inflation. Large budget deficits that require the creation or borrowing of money to facilitate government spending combined with an increase in taxes can add up to increasing inflation regardless of Fed monetary policy. Then there is the important role that regulation plays in systematically reducing economic output. Every day, the federal government supports policy and regulation changes through the executive branch and its agencies forcing prices higher.

What does all this mean today? After an unusually strong first quarter in equity markets in anticipation of a year of declining interest rates and continued economic growth, investors must take a closer look at the important role that fiscal policy plays. Will increased tightening in fiscal policy, i.e. higher tax rates, push inflation above the Fed's target? Time will tell. As this year's national elections draw nearer, fiscal policy may continue to expand to hype the strength of the economy. Without an increase in overall output to keep inflation in check, the Fed may keep interest rate targets at current levels, most likely surprising market observers who expect lower rates. Stay Tuned!

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