

Advisory Blog

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EV Forward: The Fed Cannot Contain Inflation Alone — Fiscal Policy Is Required

By: EV Forward | June 28, 2022

New York - In my view, the Federal Reserve cannot lower inflation and keep it contained within a 2% to 2.5% target range all by itself; to sustainably rein in significant inflation risks, what is required is coordination of both monetary and fiscal policy. These were the tools used to lower and contain inflation in the 1980s, and they are again necessary to lower inflation to target levels and — most importantly — keep it there.

If the Fed relies on raising interest rates alone, it may only succeed at deflating asset valuations, which might also create a recession, while inflation may remain sticky and bounce even higher once the economy recovers. It is imperative that productive capacity is increased, requiring a supply-side policy response.

Learning from the Volcker era

Today's narrative is that the Fed needs to cure the inflation infirmity only through monetary policy, much like the former Fed Chair Paul Volcker did in the 1980. This is only a half-truth, and a common misunderstanding, because — similar to the 1980s — today's inflation is being driven by a supply shock as well as an increase in demand.

A broader and more accurate account of that era would indicate that Volcker's policies created not one but two deep, back-to-back recessions that merely served to "interrupt" the rise in inflation. To completely eliminate inflation, corresponding supply-side fiscal policies were necessary.

Addressing supply and demand

Now, as then, we need a supply-side response supported by fiscal policy, in addition to a monetary policy response, which only serves to decrease demand by increasing the cost of money and credit.

We understand that the shortages in goods and labor causing higher prices and wages are not transitory; rather, they have resulted in a wage-price spiral creating persistent inflation risks. These shortages need to be addressed by fiscal policy — namely government spending, regulation and taxation designed to increase the productive capacity of the U.S. economy such that supply meets demand.

Fiscal policy is a must

Supply and demand need to work together to bring down inflation more permanently, so we must see a plan for fiscal policy in coordination with monetary policy.

If the Fed goes it alone, then it will only be using a demand tool to fix what is also a supply problem. Unless we see coordinated fiscal and monetary policy, inflation may stick around longer than market consensus suggests.

Jim Caron

Chief Fixed Income Strategist

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