

Soft Currency Economics Series

Balancing Economic Growth and Inflation in the US

Since the financial crisis and the ensuing recession that hit the US markets in 2008, we have seen several stimulus measures undertaken by the US government as well as the Fed (US Central bank). Some of these measures have been successful in promoting economic growth while some have led to unwanted inflationary pressures. As the markets and the government officials mull the next series of steps and the financial media weighs the pros and cons of such measures, I feel this is a very good time to go back to basics to understand how economic growth and inflation are balanced in the modern day economy of soft currencies. The discussion presented below draws examples from the US economy, but it is easily applicable to any modern day open economy.

A country's gross income or GDP is defined as:

$$Y = C + I + G + EX - IM \quad \text{Eq. 1}$$

Where, C is the net consumption, I is the net investment, G is government spending, EX are the exports and IM are the imports.

The national income or GDP, is then either spent in consumption (C), saved (S) or paid in taxes (T).

$$Y = C + S + T \quad \text{Eq. 2}$$

Equating (1) and (2) gives us:

$$\begin{aligned} C + I + G + EX - IM &= C + S + T \\ \Rightarrow (G - T) + (EX - IM) &= (S - I) \end{aligned} \quad \text{Eq. 3}$$

In the above equation, we can see that the left side of the above equation is the net government spending and net exports, while the right side is the net private sector savings. If we assume that net exports are zero, Equation 3 above also points to a very important fact that is commonly misunderstood by the majority of investors. Net government spending or net deficits translate directly into net private sector savings.

Government deficits = Private sector savings

Unless (G-T) increases, in other words the fiscal deficit increases, (S-I), or an individual's net savings will not increase.

Back in the days of the Gold standard, 'G' or government spending was constrained by the amount of Gold held by the Central bank. Therefore unless the amount of Gold held increased, the government could only increase spending, in excess of taxes collected, by

issuing debt. In the present day of soft currencies, ‘G’ or government spending is unconstrained. Treasuries are issued after the spending has been done as a way to offer interest bearing accounts for the money spent. Please read my article, [“Facts and Fiction of Sovereign Debt Default”](#) for further explanation of this concept.

This leads us to the next conclusion that ‘T’ or taxes collected by the government are not to generate revenues for spending but to regulate aggregate demand. Graduated tax rates regulate demand between high earners and low earners. The concept of high income earners needing to pay more taxes to promote economic growth is nothing more than politics.

Good ‘G’ and Bad ‘G’

One would ask the question, if it were really so easy, why can’t we spend our way out of the current economic malaise. Why can’t we increase ‘G’ till we reach full employment and optimal aggregate demand, what is the holdup? The answer to that question is the difference between good governance and bad governance, as misdirected ‘G’ can lead to inflation, while well directed ‘G’ can lead to full employment and price stability. The politics in Washington are all about creating good ‘G’. The philosophical debate between economists and academics is all about creating good ‘G’.

Here are a few examples from the current set of stimulus measures undertaken by the both the US government and the Fed to better understand the difference between good ‘G’ and bad ‘G’. I am going to present a pure economic analysis of these measures and not a political one as I do not believe that any political party has a monopoly on good economic sense.

Let’s refresh our memory by looking at the derived Equation 3 above:

$$(G - T) + (EX - IM) = (S - I)$$

Quantitative Easing or QE

QE is all about redirecting ‘S’. Contrary to popular belief, it does not increase government spending, ‘G’, but lowers it.

QE programs remove Treasury securities from the system, i.e. forcing investors to redirect their savings into risky assets like stocks and commodities. By removing coupon paying Treasuries from the system, the government does not have to make interest payments, thereby reducing ‘G’, which reduces the right side of the equation 3, (S-I) and hurts aggregate demand.

By removing coupon paying securities, the QE program is designed to move capital or ‘S’ into risky assets to create asset inflation. This intent was clearly stated by Fed Chief Bernanke as well at the onset of QE2 in August of 2010.

Payroll tax holiday

Payroll tax holiday reduces 'T' and thereby directly increases net savings to the private sector and stimulates aggregate demand. This is a powerful and fast way to provide stimulus to the economy.

Fed's Monetary Policy

Fed's monetary policy only controls the price of money and not the quantity of money. One could actually argue that lower interest rates means actually a lower 'G' as the coupon payments on bonds are reduced. But the main effect of lower interest rates is to lower the price of money to stimulate borrowing and investment.

Unemployment Benefits

Unemployment benefits are a social safety net meant to provide for basic consumption needs, but the prolonged program we have seen over the last few years has actually led to several economic detriments. A prolonged social safety program can lead to lack of motivation to produce, unrealistic expectations and feelings of entitlements. To read more on this subject, refer to my article on [The Detriments of Unemployment Benefits](#).

Similar social safety net programs have led to reduced productivity in not just the US but in countries around the world as well. Soviet Union, India up to the 80s and even the modern day Greek woes can be attributed to socialist policies leading to low productivity and high degrees of entitlements.

Government Bailout Spending

This measure clearly increases 'G', but the bad 'G'. Government spending policies should help in increasing the efficiency and profitability of enterprises within the country. Support for failed business models and unprofitable ventures leads to deadweight economic loss and forces the investor to redirect his savings 'S' from US businesses to foreign businesses.

Government Spending on Education and Infrastructure Projects

This is clearly one example of very good 'G'. Spending on infrastructure projects like transportation, energy and telecommunications can directly increase the efficiency of the US private enterprises. Higher efficiency can translate into higher profits, thereby attracting more of the investor's savings, 'S'. Same goes for education. A well educated and skilled population can lead to innovative ideas and the production of quality goods thereby once again increasing the profitability and attractiveness of the US enterprises and attracting investor savings, 'S'.

As explained, government spending is not constrained by anything in the current soft currency economic system. Well directed government spending policies, or good 'G', should be pursued till full employment and a sustainable aggregate demand is achieved. This will not lead to wage inflation.

Unintended Consequences of Bad government spending

Bad government spending can lead to unintended consequences, like commodity price inflation and job losses, which can lead the legislators to start blaming deficits and clamp down on spending. This is the last thing an economy with high unemployment and low aggregate demand can afford.

Examples

1. Quantitative Easing, which was a deliberate attempt by the Fed to create a demand for risky assets, spilled over and went beyond their intended target of stocks into commodities. This has led to high energy and food prices which ends up eating up more of the consumer's income for essential purchases and leaves less for discretionary spending. Less discretionary spending leads to fewer purchases of goods and services, leading the companies producing those goods and services to cut back on production and lay off employees.
2. Bad government spending which does not increase the production of quality goods in the US results in the consumer either not spending or redirecting his savings into foreign goods and services. This does nothing to help create jobs in the US but helps create jobs in countries producing those quality goods and services.

In summary, balancing economic growth with full employment and price stability is not about reducing spending and cutting deficits. On the contrary it is about increasing government spending. But, as shown above, it is about prudent government spending that leads to increased efficiency and thereby the production of quality goods and services here in the US, as bad government spending can have the opposite effect.

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