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First Trust

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Monday Morning Outlook

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Higher Inflation, Not Hyperinflation

Last year the federal budget deficit was $1.4 trillion, or 10% of GDP, the largest "peacetime" deficit on record. This year will show some improvement, but not much, with a deficit in the vicinity of 8% of GDP.

Meanwhile, the Obama Administration projects that under its own policies – including higher taxes for the "rich" and an end to hostilities in Iraq – the deficit will *never* get down to the 3% of GDP it believes is sustainable over the long run, much less the 1.2% that prevailed as recently as 2007.

Some analysts have proposed inflating/devaluing our way out of this debt crisis. These arguments have increased the fear over hyperinflation. The theory is that with deficits already so large and no immediate prospects for spending control, the US government may have to resort to an Argentina-style monetary policy to pay for its largesse. At first glance, this is not so far-fetched. Overspending in Greece has created a fiscal crisis there and some analysts think Greece would be better off leaving the Euro so they could devalue their debt.

While we are worried about rising inflation, we think the odds of hyperinflation in the US are near zero.

Right now, the public debt of the US government is $13.0 trillion. However, about $4.5 trillion is debt the government owes itself, through various trust funds. Also, the Federal Reserve owns about $800 billion in Treasury securities. While the Treasury pays interest to the Fed, the Fed pays this right back to the Treasury. As a result, the government's debt burden is about $7.7 trillion. Of this, $600 billion is in inflation-protected securities, leaving fixed debt at $7.1 trillion.

Imagine that next week the federal government pulls an Argentina, or a Zimbabwe, instantaneously increasing the money supply ten-fold, reducing the value of the dollar to what 10 cents buys today. So, the "real" (inflation-adjusted) value of the fixed debt burden on taxpayers would decline from $7.1 trillion to $710 billion, a savings of $6.4 trillion.

But this leaves out the huge amount of unfunded liabilities in Social Security and Medicare, which have a present value of about $65 trillion. That is the cost of all promises to current and future beneficiaries, over and above the revenue generated by those programs. This debt is not securitized, isn't in the form of traded bonds, but is just as much of a burden to current and future taxpayers.

And hyperinflation would do absolutely nothing to reduce these liabilities. Higher inflation today would simply increase the future spending in those programs. Social Security is directly indexed for inflation and higher inflation would drive up medical costs, too. In effect, these pension costs are a form of inflation-indexed debt.

In other words, hyperinflation would only affect the tip of the US's debt iceberg. But think about all the damage the economy would suffer just to influence that tip. Hyperinflation would reduce the value of our savings, raise the effective tax rate on capital gains, make depreciation schedules much less attractive, and drive up risk premiums. The cost of capital would soar and investment would plummet, particularly for long-dated projects.

With these costs in mind, it is hard to make the case that the long-term fiscal position of the federal government would improve through a policy that reduces the value of traded debt, but not the future value of unfunded spending obligations. And remember, that's with a tenfold increase in consumer prices. Meanwhile, at an average maturity of 4 years 7 months, the federal government would have to start rolling over a large portion of its debt at substantially higher interest rates.

Hyperinflation, with a side order of devaluation, is not a free lunch. That was a lesson learned all too well in the 1970s. And now, with future entitlement spending making the current securitized debt small by comparison, it makes even less sense for the government to pursue.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-19 / 9:00 am	Leading Indicators - Mar	1.0%	**+1.3%**	+1.4%	+0.1%
4-22 / 7:30 am	PPI - Mar	+0.5%	**+0.7%**		-0.6%
7:30 am	"Core" PPI - Mar	+0.1%	**+0.1%**		+0.1%
7:30 am	Initial Claims - Apr 10	450K	**463K**		484K
9:00 am	Existing Home Sales - Mar	5.300 Mil	**5.210 Mil**		5.020 Mil
4-23 / 7:30 am	Durable Goods - Mar	+0.2%	**-0.8%**		+0.9%
7:30 am	Durable Goods (Ex-Trans) - Mar	+0.7%	**+0.7%**		+1.4%
9:00 am	New Home Sales - Mar	0.325 Mil	**0.330 Mil**		0.308 Mil