First Trust
Monday Morning OUTLOOK

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It's Money, Not Spending, that Causes Inflation

You don't have to read or listen for long these days before you hear a politician, pundit, or politically-inclined person say: "Government spending causes inflation."

Don't get us wrong…anyone who wants to cut the size and scope of government is a friend of ours. Government is **WAY** too big. It slowed the growth rate of the economy, hurt living standards, and made people fight over fixed slices of the pie rather than working to grow the pie. But, government spending, itself, doesn't cause inflation.

Just think about it. If government taxes (or borrows) $1,000 from Peter and gives that $1,000 to Pauline…Peter doesn't have it, but Pauline does. Is there any more money in the economy? Absolutely not.

The only thing that can increase inflation – in fact, the definition of inflation – is excess money creation. Inflation is a decline in the purchasing power of a currency caused by central banks that inject more money into an economy than an economy really needs. Inflation isn't an increase in the prices of goods and services, it's a decline in the value of money. And government spending, all by itself, does not increase the money supply.

And if you don't believe us, how about Milton Friedman? He wrote "Fiscal policy is extremely important in determining what fraction of total national income is spent by government and who bears the burden of that expenditure. By *itself*, it is not important for inflation."

Some people wrongly assume that government borrowing creates money. But think about it. Who does the government borrow from? China, Japan, retirees, and banks all buy Treasury bonds. They buy them with dollars that they earned exporting to the US, working for incomes, or taking in deposits.

If any entity buys the debt of the US they no longer have the cash, the government does. Like Peter and Pauline, it is just a transfer of cash from one account to another. It doesn't increase spending. If China buys debt, then they can't buy imports with those same dollars. If banks buy debt, then they can't make loans with that same money.

What is true is that if the Fed (or any central bank) creates new money (say with QE) and buys government debt, this injects new money into the economy. That IS inflationary. But it's the money creation that caused the inflation, not the spending itself.

We think government spending needs to be cut. In fact, it may be the most important policy proposal on the table today. But we should cut spending for the right reasons. Making mush of economics doesn't help anyone in the long run.

In that vein, many people correctly point out that the more the government borrows and taxes, the less the private sector has. This slows the growth of the economic pie and holds back the production of goods and services. Fewer goods and services, with the same monetary policy, means higher prices than we would have if government were smaller.

But this is not inflation, it is a (negative) supply-side boost in prices. The Fed could pull money growth back in such a situation and keep prices from rising as much, but the Fed actually does the opposite. The slower the economy grows, the more likely the Fed is to print excess money to boost it.

Again, this excess money is what causes the inflation, not the government spending. Even though a bigger government holds back output, it is not the ultimate cause of inflation.

The US was able to fix the inflation of the 1970s by slowing down the growth rate of the money supply. And, contrary to popular belief, the US does not need easy money and low interest rates to grow. In fact, the high-tech sector has thrived with declining prices.

Let's cut spending for the right reasons. We get it: if saying spending creates inflation and that bumper sticker argument gets voters on board it would be easy. But the real reason to cut the size of government is to create more of a free market, reduce corruption, and allow workers to keep more of what they earn.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-16 / 7:30 am	Empire State Mfg Survey – Sep	-4.0	**-11.3**	11.5	-4.7
9-17 / 7:30 am	Retail Sales – Aug	-0.2%	**-0.3%**		+1.0%
7:30 am	Retail Sales Ex-Auto – Aug	+0.2%	**+0.3%**		+0.4%
8:15 am	Industrial Production – Aug	+0.2%	**+0.1%**		-0.6%
8:15 am	Capacity Utilization – Aug	77.9%	**77.8%**		77.8%
9:00 am	Business Inventories – Jul	+0.3%	**+0.3%**		+0.3%
9-18 / 7:30 am	Housing Starts – Aug	1.316 Mil	**1.310 Mil**		1.238 Mil
9-19 / 7:30 am	Initial Claims – Sep 9	230K	**230K**		230K
7:30 am	Philly Fed Survey – Sep	-1.0	**-5.2**		-7.0
9:00 am	Existing Home Sales – Aug	3.900 Mil	**3.910 Mil**		3.950 Mil