FAQ: Government Intervention & Inflation

The U.S. government responded swiftly to the economic blow dealt by COVID-19 and the virus containment efforts by pouring billions into the hands of consumers and small businesses. The questions we ask and hear from our clients focus on how the massive relief packages will be funded, and the relationship between government debt and inflation.

In our response to this FAQ, 1919 Investment Counsel addresses your questions about how this intervention and the resulting dramatic increase in government debt will affect us as consumers, investors, and taxpayers.

Can the U.S. Government afford this debt?

There is no doubt that the level of U.S debt will increase substantially in the near term. The Congressional Budget Office (CBO) estimates debt to reach 108% of GDP by the end 2021, compared to 79% at the end of fiscal year 2019. The level of U.S. debt will likely climb even higher if further support packages are passed by Congress. However, this increased debt level does not automatically mean higher inflation. As an imperfect point of comparison, Japan's debt-to-GDP ratio is well above 200%, but without indications of inflation. Japan faces deep long-term structural forces such as an aging population, which the U.S. also deals with, although to a lesser extent. The demographic trend of an aging population has put downward pressure on inflation in recent years and is expected to continue.

With U.S. Treasury yields near all-time lows across the yield curve, the interest cost on our U.S. debt remains very manageable. Therefore, despite the higher debt load, the interest cost to service the higher debt load remains low. This in turn argues that the U.S. has the capacity for markets to absorb all the new debt without driving interest rates or inflation materially higher.

How does all of this debt impact inflation?

For the near term, impacts from the COVID-19 pandemic should keep inflation muted in light of these current trends: elevated unemployment, lower personal consumption, and GDP contraction. Even before the pandemic, inflation measures consistently undershot the Fed's 2% target. For March 2020, the personal consumption expenditures (PCE) index rose 1.3% year over year, down from 1.8% in February 2020. The core PCE index, which excludes food and energy and is the Fed's preferred metric, rose 1.7% year over year in March 2020. Both measures remain below the Fed's 2% goal. Aside from a few months in mid-2018, core PCE has not risen above 2% since 2012.

In recent comments, Fed Chair Powell made it clear that he does not view inflation as a near-term concern, especially with weaker consumer demand and significantly lower oil prices generating downward pressure on inflation. Rather, the Fed is focused on using a broad range of monetary policy and lending tools to support the U.S. economy through the current crisis.

Can the U.S. experience hyperinflation?

To address the question of hyperinflation, we dusted off our history books. We note that the hyperinflation experienced in Germany in the 1920s and early 1930s leading into World War II was primarily due to the country owing war reparations in gold, rather than in its own currency. Germany responded by printing more and more paper marks, which were continuously devalued against this external hard currency debt. Because U.S. debt is issued in our own currency and the U.S. dollar remains the primary reserve currency for the world (~60% of total reserves, according to the IMF), there is little risk of hyperinflation.

In summary, we acknowledge that U.S. government debt is expected to increase dramatically in response to the COVID-19 crisis. However, the weak condition of the U.S. economy makes a significant increase in inflation unlikely in the near term. Rather, we view the current economic risks as tilted toward disinflation. Concerns around higher inflation may resurface once we are past the immediate crisis phase of the pandemic, and cannot be ruled out as a longer-term concern.