

Morgan Stanley

INVESTMENT MANAGEMENT

The Fed Cannot Contain Inflation Alone - Fiscal Policy Is Required

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | June 2022

Containing Inflation

The Fed cannot lower inflation and keep it contained within its 2 - 2.5% target all by itself. What is required is coordination between both monetary and fiscal policy in order to sustainably rein in significant inflation risks. These were the tools used to lower and contain inflation in the 1980s and are again necessary to lower inflation to target levels and, most importantly, keep it there.

Supply AND Demand

The narrative forwarded today 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 1980s. However, this narrative is only a half-truth because, similar to the 1980s, today's inflation is being driven by a supply shock as well as an increase in demand. This means that a supply-side response supported by fiscal policy is needed in addition to a monetary policy response, which only serves to decrease demand by increasing the cost of money and credit.

It is understood now that the shortages in goods and labor that brought about higher prices and wages were not transitory, but instead resulted in a wage-price spiral that has created persistent inflation risks. These shortages need to be addressed by fiscal policy, namely government spending, regulation and taxation, all designed to increase the productive capacity of the U.S. economy **such that supply meets demand**. If the Fed relies on raising interest rates alone, it may only succeed at deflating asset valuations. The focus on monetary policy alone might also create a recession, but 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.

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A Lesson From the Volcker Era

A common misunderstanding is that aggressive rate hikes by Volcker in the 1980s solved the inflation problem, period. However, a broader and more correct account would indicate that Volcker's policies created not one, but two, back-to-back and very deep recessions that merely served to "interrupt" the rise in inflation. His actions would not have completely eliminated inflation without corresponding supply-side fiscal policies.

Fiscal Policy Is a Must

That's what's missing today. We need to see a plan for a fiscal policy to work in coordination with monetary policy. Supply and demand need to work together to bring down inflation more permanently. If the Fed goes it alone, then it will be using only a demand tool to fix a supply problem. Unless we see coordinated fiscal and monetary policy, inflation may stick around longer than market consensus suggests.

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