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How Can Budget Deficits Influence Inflation?

By Leo Kamp, TIAA-CREF Economist

Budget deficits have the potential for increasing inflation, but the impact depends critically upon the extent of central bank “monetization.” Monetization occurs when a central bank, like the Federal Reserve, buys government debt (accumulated from past and present budget deficits) with newly created “high powered money” (i.e., increased central bank liabilities in the form of currency or bank reserves). Inflation may rise with increased monetization, especially when it is extreme (e.g., the central bank finances a large portion of the deficit).

Indeed, hyperinflation (i.e., very high inflation rates) has occurred historically when central banks have chosen to monetize government deficits aggressively, such as in certain Latin American countries (e.g., Brazil, Argentina and Mexico). During the 1980s, many Latin American central banks, under political pressure, continued to monetize a large portion of budgetary deficits, resulting in continued high rates of inflation. But, during the 1990s, as central banks in the region gained increased political independence, the degree of central bank monetization diminished sharply. As a result, inflation rates in the region fell dramatically, with just single-digit rates of inflation being registered in those countries today.

In the United States and Europe, the inflationary impact from deficits is likely to be quite small. Central banks in those areas, all of whom are independent, have shown no inclination to aggressively monetize deficits. Furthermore, some central banks in those areas (e.g., the European Central Bank, the Bank of England) are constrained by formal inflation targets. As a result, it is very unlikely that budget deficits will be monetized there. Without monetization, the inflationary impact of deficits is likely to be subdued. Indeed, without monetization, increasing deficits tend to raise real interest rates and perhaps diminish real economic growth by “crowding out” investment and — via an appreciating real dollar exchange rate — net exports. (Note: The real interest rate is the current interest rate minus expected inflation.)

To read more about Leo Kamp's articles on the economy, go to the "Kamp's Comments" section of the TIAA-CREF website at www.tiaa-cref.org/about/press/index.html.

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