INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Federal Open Markets Committee meeting, US Fed. 28-29/7/2021

Fed remains in denial about inflation

After reaching 5% in the year to May, consumer price inflation in the USA rose further to 5.4% a month later, the highest reading since August 2008. Producer prices rose higher still, reaching 7.3% over the same period. This suggests that the USA could be heading for a prolonged period of high inflation, especially given the surge in broad money growth in recent months. June saw only a modest increase - $24b. – in M3, but the values for each of the previous four months have been over $200b., with May's reading of $251b. the highest since June 2020.

At the most recent meeting of the Federal Reserve's Federal Open Markets Committee, however, the vote to continue with the very expansive monetary policy was unanimous. Members still believe that the inflationary surge will be transitory (although Chairman Powell did admit in the ensuing press conference that "bottleneck effects have been larger than anticipated" – in other words, high inflation can be blamed on more persistent disruptions to supply chains and worse labour shortages than the Fed expected. The expectation was that once these issues would be addressed, inflation would sink back to a level closer to the 2% target. The elephant in the room – high broad money growth – did not receive any mention in the press conference or the ensuing press release. Mr Powell was pressed by several reporters about the high level of inflation His response was quite extraordinary: "inflation is running well above our 2 percent objective and has been for a few months and is expected to run up certainly above our objective for a few months before we believe it'll move back down toward our objective." In other words, no monetary tightening would be required to bring it back down to 2%. Indeed, the FOMC seems far more concerned that the US economy has not fully recovered from the pandemic and that unemployment levels need to fall further before any tightening of monetary policy can be considered. So the Fed Funds rates will stay at 0% to 0.25% and the Fed will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage‑backed securities by at least $40 billion per month.

By contrast, the Institute of International Monetary Research expects inflation to remain between 5% and 10% for much of the next 18 months unless monetary policy is tightened before then. Back in the spring of 2020, we predicted higher than 5% inflation when the consensus said that deflation was a far greater risk. With a significant fiscal deficit for 2021 being financed by banks and central banks and more money likely to be created once borrowing by businesses returns to more typical levels seen prior to the pandemic, inflation will not drop back to 2% for some time unless the Fed changes its tune.

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