Dramatic jump in the money supply is the real cause of inflation

John Plender (The Long View, May 7) is not alone in believing that "the rate of interest", as measured by bond yields and the central bank rate, defines monetary policy.

But the Federal Reserve's actions on interest rates cannot explain the current inflation surge. The federal funds rate was lowered from a bit above 1.5 per cent in February 2020, just before the Covid emergency, to virtually nil a few weeks later. But the move was trivial compared with the truly inflationary 1970s, when the federal funds rate was sometimes in double digits and reductions in it occasionally exceeded 500 basis points in one year. It must also be remembered that the federal funds rate was under 0.5 per cent continuously in the eight years to November 2016, a period of negligible inflation.

The dominant cause of the current rapid inflation is an extraordinary jump in the quantity of money. In the three years to the end of 2021, the broadly defined money measure M3 increased by almost 45 per cent. This was larger than the 33 per cent increase in M3 in the entire previous decade.

From the spring of 2020, too much money was chasing too few assets. Excess money was the driving force behind the strength of the US stock market and the buoyancy of house prices.

In February 2022, house prices were over 42 per cent higher than three years earlier, according to the Federal Housing Finance Agency index. By contrast, the almost zero interest rates of the eight years to November 2016 were associated with an average house price gain of only 3.5 per cent a year.

The latest Fed announcement of large planned asset sales signals an early collapse in money growth and may even lead to a contraction in the quantity of money. Severe tightness in monetary policy would then be a huge worry for asset markets.

Professor Tim Congdon
Chair, Institute of International Monetary Research, University of Buckingham
Buckingham, UK