INSTITUTE OF INTERNATIONAL MONETARY RESEARCH
Analysis and insight into trends in money and banking, and their impact on the world's leading economies
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Will the rise in US inflation be temporary, persistent or permanent?

A presentation by Professor Tim Congdon CBE,
Chairman of the Institute of International Monetary Research,
in May 2021

The causes of inflation

- The cause of inflation is excessive growth of the quantity of money, broadly-defined. (I am not interested – in this context – in the monetary base, the size of the central bank balance sheet, M1 etc.)
- So the underlying cause of the current US inflation upturn is the acceleration in money growth that began ***in 2019*** and was at its most vigorous in spring 2020, when – in the four months to June – M3 rose by 18.8%. **The spring 2020 money surge was the main reason that US M3 money growth in the year to June 2020 was 26.0%, the highest figure since 1943.**
- Since then money growth has been slower, but in the three months to March it was 10.3%, at an annualised rate. This is still high/very high by US standards in the last decade or so.

The analysis from the Institute of International Monetary Research has been correct

- It has been correct in two respects,

- The Institute's view, right from the very start of the spring 2020 money growth acceleration, has been that – because of the policy response to it – the Covid-19 pandemic would lead to an inflationary boom. Last spring this was very much a minority position.
- Our view has highlighted the contrast between the USA, where the money growth surge was pronounced and frankly extraordinary, and other advanced countries, where money growth has also risen significantly, but not to the same degree as in the USA.

How wrong can you be? –
Initial responses by top mainstream economists to the Covid-19 pandemic – **The FOMC**

A view from the Federal Reserve's Open Market Committee

- *From the* Minutes *of the 9 – 10 June meeting:*

"The [forward-looking] simulations [from the Fed's research staff] suggested that the Committee would have to maintain highly accommodative financial conditions for many years to quicken meaningfully the recovery from the current severe downturn."

- Notice the phrase ***"for many years"***.

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The coronavirus pandemic is inflationary

A presentation by Professor Tim Congdon CBE,
Chairman of the Institute of International Monetary Research,
in March 2020

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The coronavirus pandemic, the quantity of money and asset prices

May 2020 presentation
by Professor Tim Congdon CBE,
Chairman of the Institute of International Monetary Research
at the University of Buckingham

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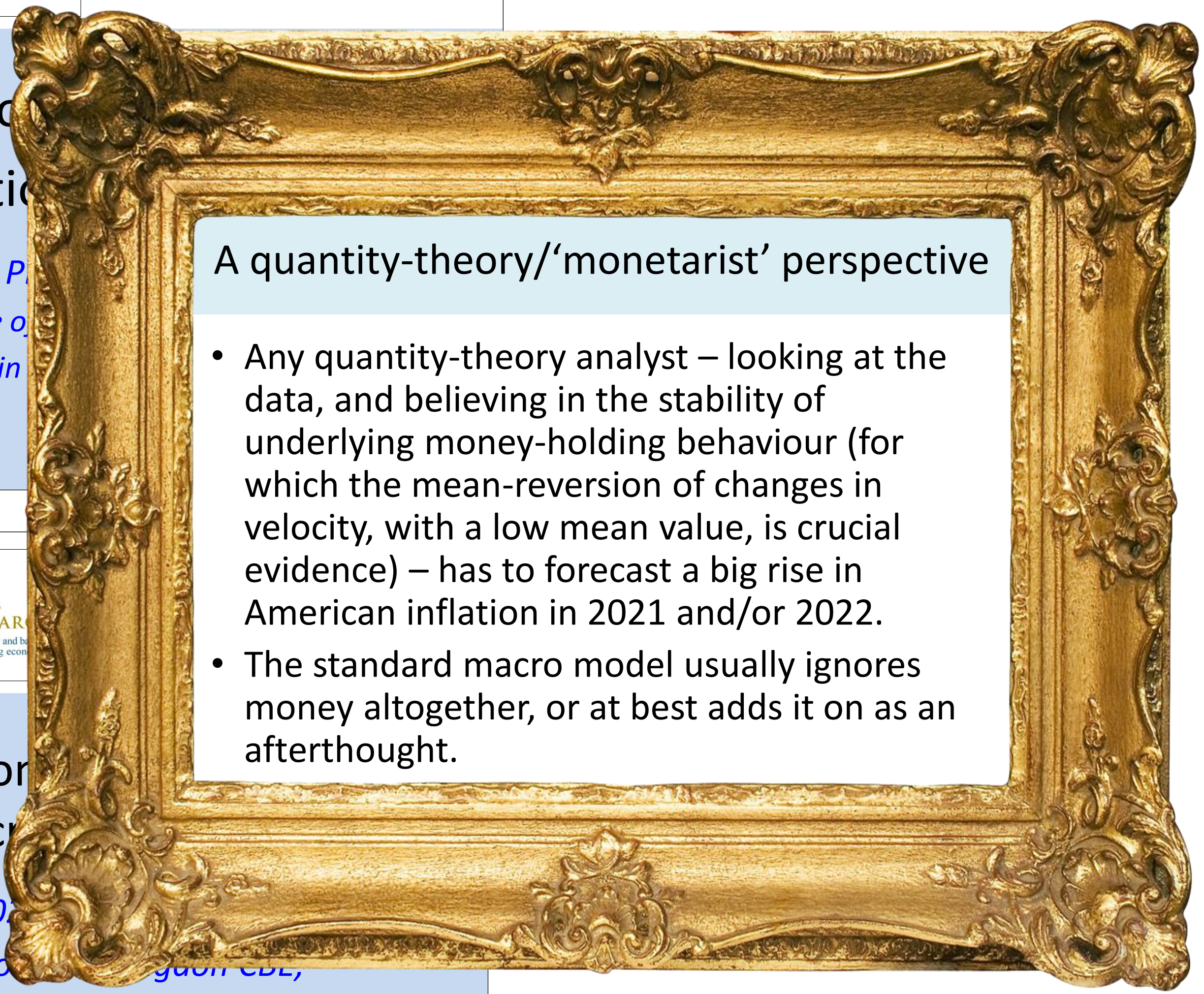
Putting the coror
long-run mac

July 20
by Professo gdon CBE,
Chairman of the Institute of International Monetary Research
at the University of Buckingham



A quantity-theory/'monetarist' perspective

- Any quantity-theory analyst – looking at the data, and believing in the stability of underlying money-holding behaviour (for which the mean-reversion of changes in velocity, with a low mean value, is crucial evidence) – has to forecast a big rise in American inflation in 2021 and/or 2022.
- The standard macro model usually ignores money altogether, or at best adds it on as an afterthought.

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A quote from a 6th April 2020 special e-mail from the Institute

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Does the Fed understand what it is doing?

At some point – probably in mid- or late 2021 – the coronavirus crisis will be over…And what will then happen to the 'excess over normal' money balances created by public policy in 2020 and early 2021? The answer is that – as in the aftermath of wars – an inflationary boom in the world's leading economy has to be the central forecast. **It seems to me that a major increase in inflation due to this boom is inevitable. Whether that increase is to 5% or 10%, no one knows for certain yet…**

The causes of inflation

- In understanding the present situation, **it is very important to realize that the Federal Reserve is not interested in the behaviour of the quantity of money at all.**
- **The Federal Reserve does not refer to the quantity of money, as measured by any aggregate, in its policy statements. (The FOMC Minutes are an example.)**
- To the extent that Federal Reserve research notices the quantity of money, the references tend to be dismissive – and sometimes downright rude. (In qualification, some Federal Reserve districts do have strong traditions of monetary analysis, although – for my taste – they are too concerned with the monetary base, the size of the central bank balance sheet, M1 etc.)

The causes of inflation

- FOMC Minutes for 28th and 29th April meeting contained the observation,

"The staff continued to judge that the risks to the baseline projection for economic activity were skewed to the downside…"

US inflation in the next few months

- Box has alternative projections in an article in winter 2020/21 issue of *The International Economy.* **Update in red circle.**

In May 2020 the US CPI fell by 0.1%. So an increase of 0.4% in May 2021 would cause the annual rate to rise **from 4.2% to 4.7%.**

Annual increase in US consumer price index in 2021, for two different trajectories of the monthly increase

	0.2% a month increase	*0.45% a month increase*
January	1.3	1.6
February	1.5	2.0
March	2.1	2.9
April	3.1	4.1
May	3.4	4.7
June	3.0	4.6
July	2.6	4.4
August	2.4	4.5
September	2.4	4.8
October	2.6	5.2
November	2.6	5.4
December	2.4	5.5

US inflation in the next few months

- Rather high increases in the CPI were recorded in June and July 2020, but the CPI was unchanged in the final quarter of 2020.

A plausible view is that the monthly increases in 2021 will average 0.4% from now on. **On that basis the annual rate will exceed *5%* in the final quarter of 2021.** Note that the annual increase in producer prices is already 6.2%.

US inflation in the next few months

- **IHS Markit Flash U.S. Services PMI™**

The seasonally adjusted IHS Markit Flash U.S. Services PMI™ Business Activity Index registered70.1 in May, up from 64.7 in April.

"The rate of expansion was the sharpest since data collection for the series began in October 2009…New order growth also accelerated to the fastest on record…**Inflationary pressures continued to mount in May, as rates of increase in input prices and output charges quickened to the steepest on record.** Companies commonly noted efforts to pass through soaring costs to clients, with prices of oil, PPE and transportation often cited as fuelling the uptick in expenses…"

US inflation in the next few months

- **IHS Markit Flash U.S. Manufacturing PMI™**
- Goods producers registered arecord rate of improvement inoperating conditions during May, as highlighted by theIHS Markit Flash U.S. Manufacturing Purchasing Managers' Index™(PMI™)1posting 61.5, surpassing April's previous series high of 60.5.
- "…Input costs rose in May at a pace not seen since July 2008. The uptick in inflation was widely attributed to higher logistics, raw material and fuel costs, with firms commonly reporting soaring vendor prices and difficulties sourcing materials amid a further severe lengthening of supplier delivery times. **Companies made efforts to pass higher cost burdens onto clients, causing output charges to rise at the steepest rate on record**."

Signs of upward pressure on labour costs

CHICAGO, Ill., May [13], 2021-- McDonald's will be raising hourly wages for more than 36,500 hardworking employees at McDonald's-owned restaurants **by an average of 10 percent**. These increases, which have already begun, will be rolled out over the next several months and include shifting the entry level range for crew to at least $11 - $17 an hour, and the starting range for shift managers to at least $15 - $20 an hour based on restaurant location.

Signs of upward pressure on labour costs

May 18, 2021 at 10:42 AM Eastern

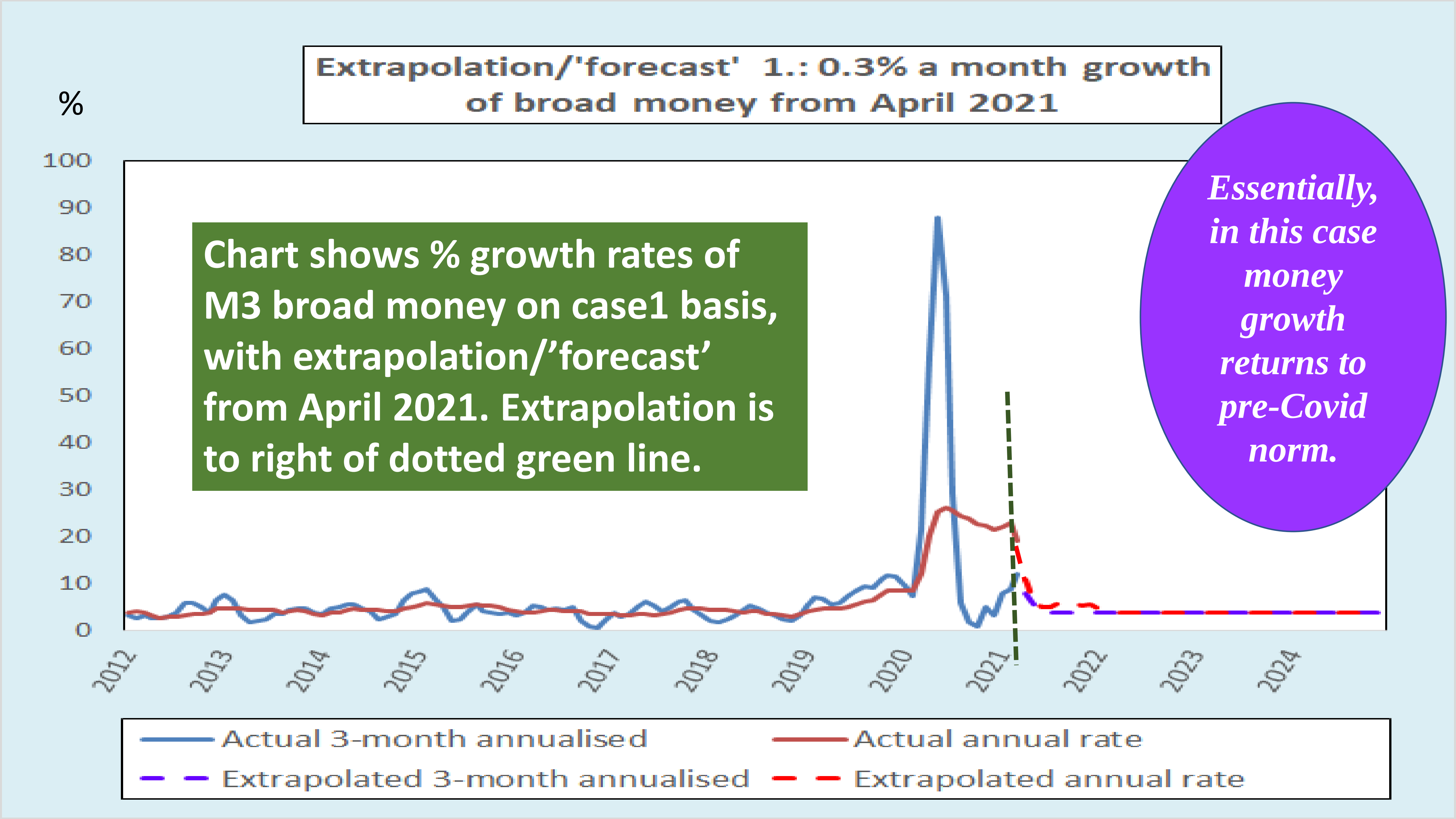
Today, Bank of America announced it will raise **its U.S. minimum hourly wage to $25 by 2025. In March last year, the company raised its U.S. minimum wage to $20 per hour.**

In addition, Bank of America announced that all its U.S. vendors are now required to pay their employees dedicated to the bank, at or above $15 per hour. Today, over 99% of the company's more than 2,000 U.S. vendor firms and 43,000 vendor employees are at or above the $15 per hour rate, as a result of the implementation of this policy.

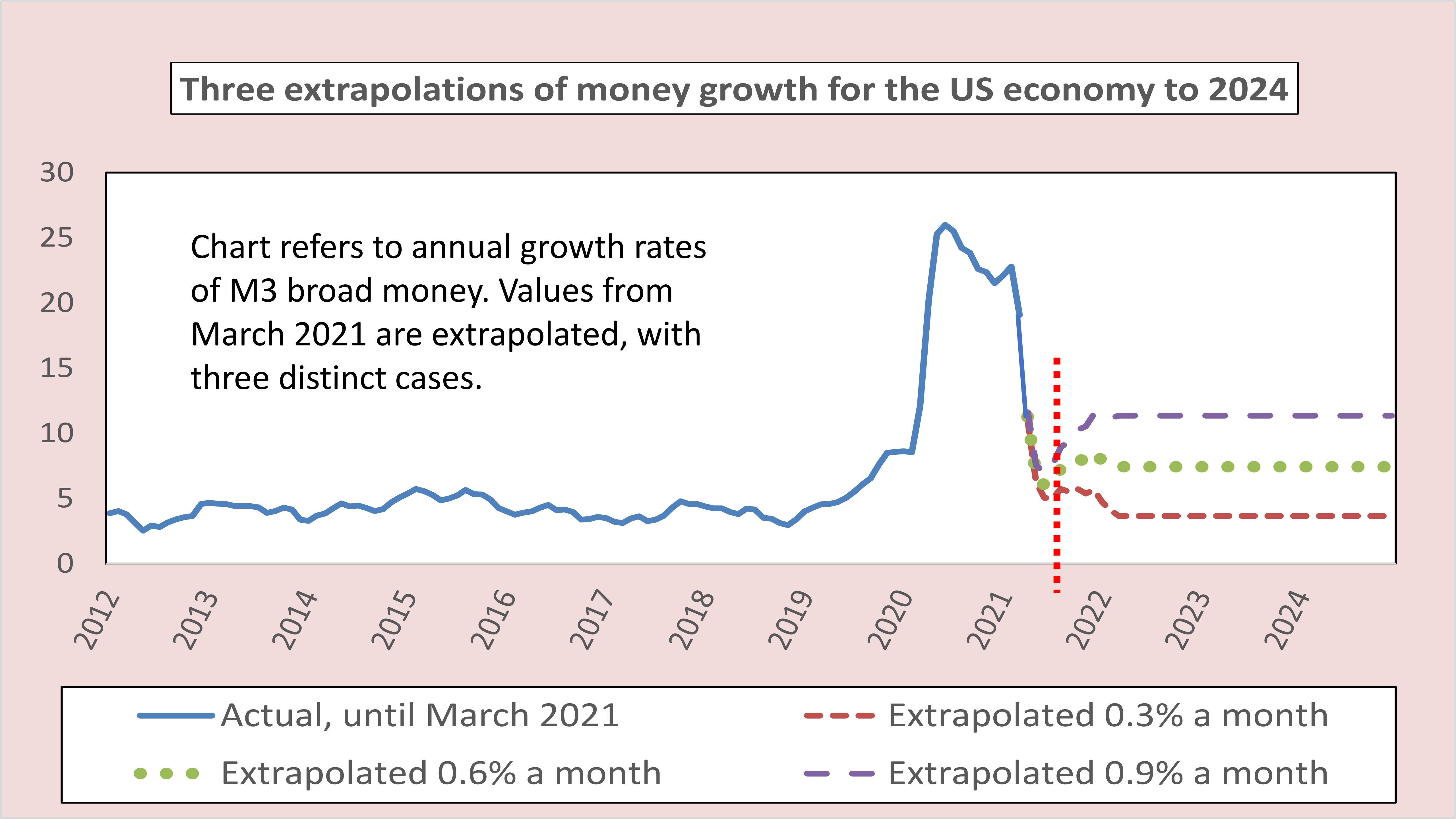
US inflation over the medium term

- The current upturn in US inflation has been caused by a dramatic acceleration of money growth, where the quantity of money is broadly-defined. The behaviour of the relevant price levels (of assets, and of the goods and services that are included in national output/income) has been consistent with the monetary theory of national income determination.

- **The prospect for inflation – and the answer to the question whether the increase in in inflation will be temporary, persistent or permanent – depends on recent and future rates of change in the quantity of money, broadly-defined.**



Extrapolation/'forecast' 1.: 0.3% a month growth of broad money from April 2021
%
100
90
80
70
60
50
40
30
20
10
0
Chart shows % growth rates of M3 broad money on case1 basis, with extrapolation/'forecast' from April 2021. Extrapolation is to right of dotted green line.
Essentially, in this case money growth returns to pre-Covid norm.
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023
2024
Actual 3-month annualised
Actual annual rate
Extrapolated 3-month annualised
Extrapolated annual rate


Three extrapolations of money growth for the US economy to 2024
Chart refers to annual growth rates of M3 broad money. Values from March 2021 are extrapolated, with three distinct cases.
30
25
20
15
10
5
0
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023
2024
Actual, until March 2021
Extrapolated 0.3% a month
Extrapolated 0.6% a month
Extrapolated 0.9% a month

Case 1 extrapolation/'forecast'

- Money growth is assumed to return to the pre-2019 norm, i.e., 0.3% a month or almost 4% a year, in line (curiously) with Friedman's 1959 recommendation on the rate of money growth necessary for price stability. Average money growth in five years to 2023 is 8.6%.
- **Slower money growth from mid-2021 makes negative real money growth in 2022 more likely.**
- **Verdict: Inflation in the 5% -10% band for a few quarters, mostly in 2022, but returns to 2% or less by mid-2020s, probably after a recession in late 2022/early 2023.**

Money growth rates each year

2019	8.6
2020	21.5
2021	5.7
2022	3.7
2023	3.7
Average rate of money growth in five years to 2023	8.6

Case 2 extrapolation/'forecast'

- Money growth is assumed to stay above the pre-2019 norm, i.e., 0.6% a month. Average money growth in five years to 2023 is 10.7%. Slower money growth from mid-2021 makes negative real money growth in 2022 more likely.
- **Verdict: Inflation in the 5% -10% band for a few quarters, mostly in 2022, and stays in the 2% - 5% area in the mid-2020s. Beneath-trend growth likely from late 2022. (There is a short-run trade-off between growth and inflation.)**

Money growth rates each year

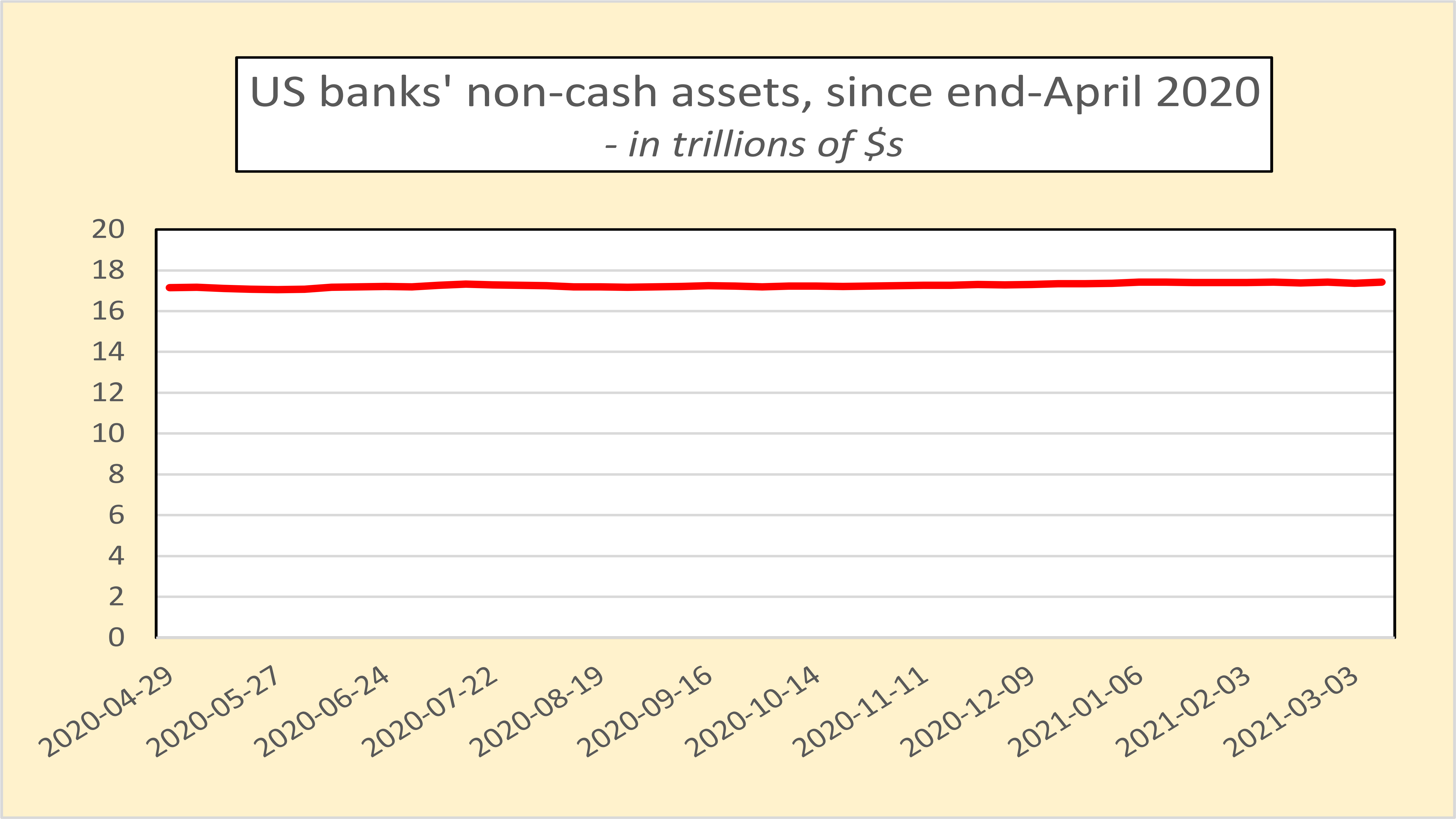
2019	8.6
2020	21.5
2021	8.5
2022	7.4
2023	7.4
Average rate of money growth in five years to 2023	10.7

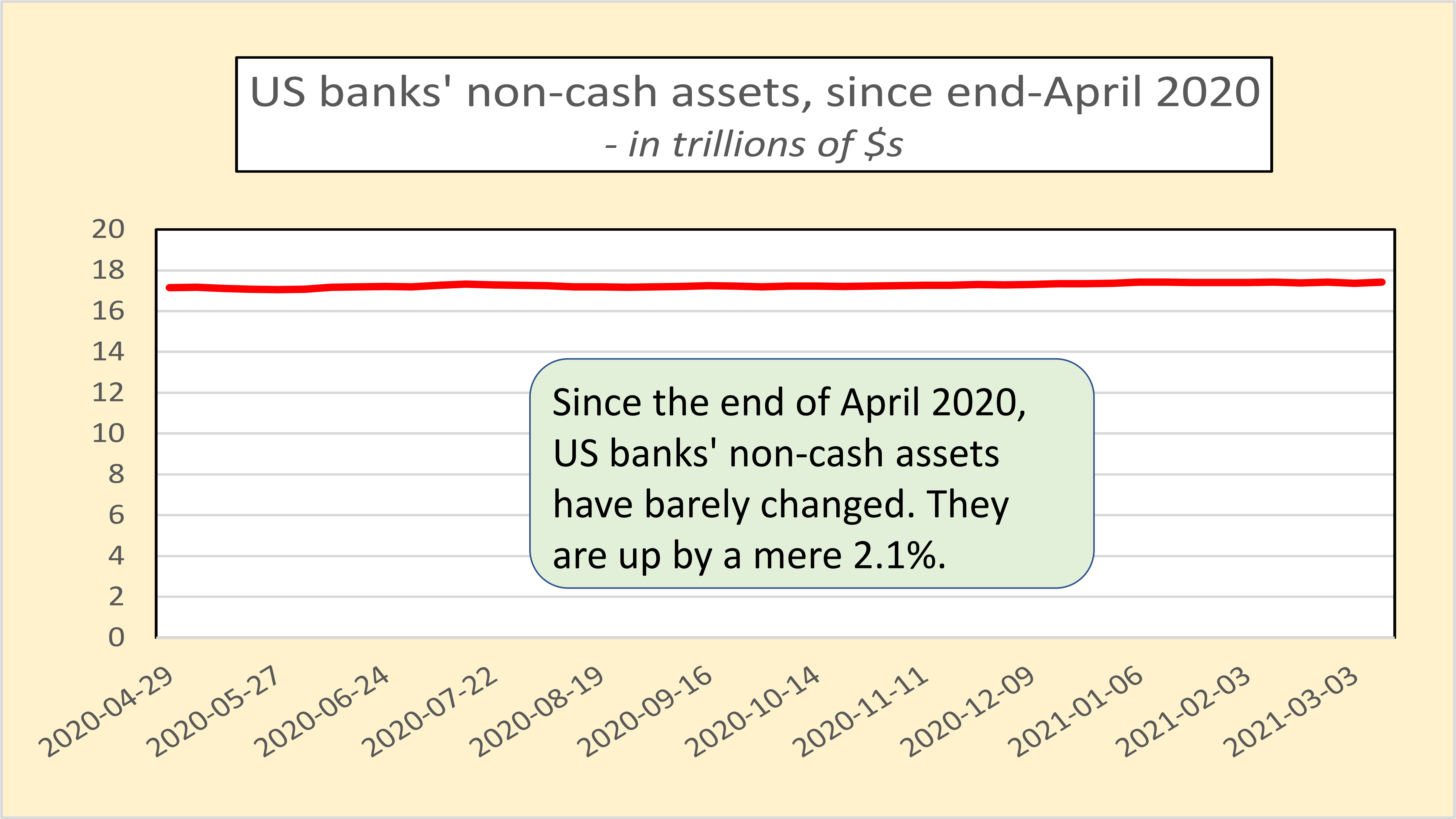
Case 3 extrapolation/'forecast'

- Money growth is assumed to stay well above pre-2019 norm, i.e., 0.9% a month. Fed is monetizing deficit, Fed may stop asset purchases but doesn't start asset sales etc. Average money growth in five years to 2023 is 12.9%.
- **Verdict: Inflation in 2022 and even 2023 has to catch up with money growth rate. Inflation rises to double digits % p.a., but beneath-trend output growth postponed, perhaps to late 2023 or even 2024. With money growth just in double digits, inflation may be in high single digits much of the time, but sometimes in double digits.**

Money growth rates each year

2019	8.6
2020	21.5
2021	11.5
2022	11.4
2023	11.4
Average rate of money growth in five years to 2023	12.9


US banks' non-cash assets, since end-April 2020
- in trillions of $s
20
18
16
14
12
10
8
6
4
2
0
2020-04-29
2020-05-27
2020-06-24
2020-07-22
2020-08-19
2020-09-16
2020-10-14
2020-11-11
2020-12-09
2021-01-06
2021-02-03
2021-03-03



US banks' non-cash assets, since end-April 2020
- in trillions of $s
20
18
16
14
12
10
8
6
4
2
0
Since the end of April 2020, US banks' non-cash assets have barely changed. They are up by a mere 2.1%.
2020-04-29
2020-05-27
2020-06-24
2020-07-22
2020-08-19
2020-09-16
2020-10-14
2020-11-11
2020-12-09
2021-01-06
2021-02-03
2021-03-03

Summary: return to slower money growth likely, but inflation to stay high for some quarters – US recession risks 18 months to three years from now

- The current rise in US inflation is explained by the leap in broad money growth last spring and is consistent with the monetary theories of the determination of national income and the price level.
- The Fed's research and modelling sees no role for any money aggregate in the determination of any macroeconomic variable.
- Demand and output will rise strongly, as life returns to normal after the medical emergency, in the next three to six months. Inflation pressures – already serious – will intensify, and the annual rate of CPI inflation will go above 5%.
- Money growth will slow, despite the huge budget deficit, when the Fed ends its asset purchases. Slowing money growth and rising inflation signal a contraction in real money balances, which will undermine asset prices and cause beneath-trend growth…or even a recession (with 2023 the most likely year for this).

Summary: will annual inflation of about 5% be temporary, persistent or permanent?

- The length of the current US inflation outbreak will depend on future broad money growth rates.
- My expectation, but hardly my conviction, is that the annual rate of US broad money growth will return – in the next three to six months – to 4% or so, the sort of numbers seen for most of the 2010s. If so, the current inflation outbreak will be temporary.
- **But policy decisions – and the monetary data – have to be watched. If money growth stabilizes at around 1% a month (i.e., at an annual rate of almost 13%), annual US inflation is likely to be in double digits much of the time...on a persistent or even permanent basis.**