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The rise in US inflation has been caused by excessive growth of the quantity of money: *towards the final stages of the debate?*

A presentation by Professor Tim Congdon CBE,

Chairman of the Institute of International Monetary Research,

in September 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 seven months to July it was 9.0%, 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.

What is the FOMC thinking?

- With the *Minutes* to its **June** meeting, the FOMC included a ‘central tendency’ projection of PCE inflation in Q4 2021 of 3.1% - 3.5%, i.e., **3.3% in the middle**.
- The *Minutes* of its **July** meeting (of 27/28 July) contained a paragraph-long discussion…..

What is the FOMC thinking?

- Here is the paragraph in the *Minutes* of its **July** meeting:

“The staff’s near-term outlook for inflation was revised up further in response to incoming data…**The staff expected the increase in PCE prices to move down gradually in the second part of 2021, reflecting a moderation in monthly inflation rates and the waning of base effects**; even so, PCE price inflation was projected to be running well above 2 percent at the end of the year.”

- In the next paragraph, the staff is reported as believing that “the risks to the baseline projection for economic activity were **skewed to the downside**”.

What is the FOMC thinking?

So how large “a moderation in monthly inflation rates”, plus a “waning of base effects”, is needed from here to deliver PCE inflation of 3.3% in, say, December 2021?

Is the FOMC thinking at all?

On 27 August the Bureau of Economic Affairs published its latest monthly release on consumer expenditure, with the July PCE number. **The increase in the PCE deflator, using the seasonally adjusted series, in the seven months from December 2020 to July 2021 was *3.2%*.**

Is the FOMC thinking at all?

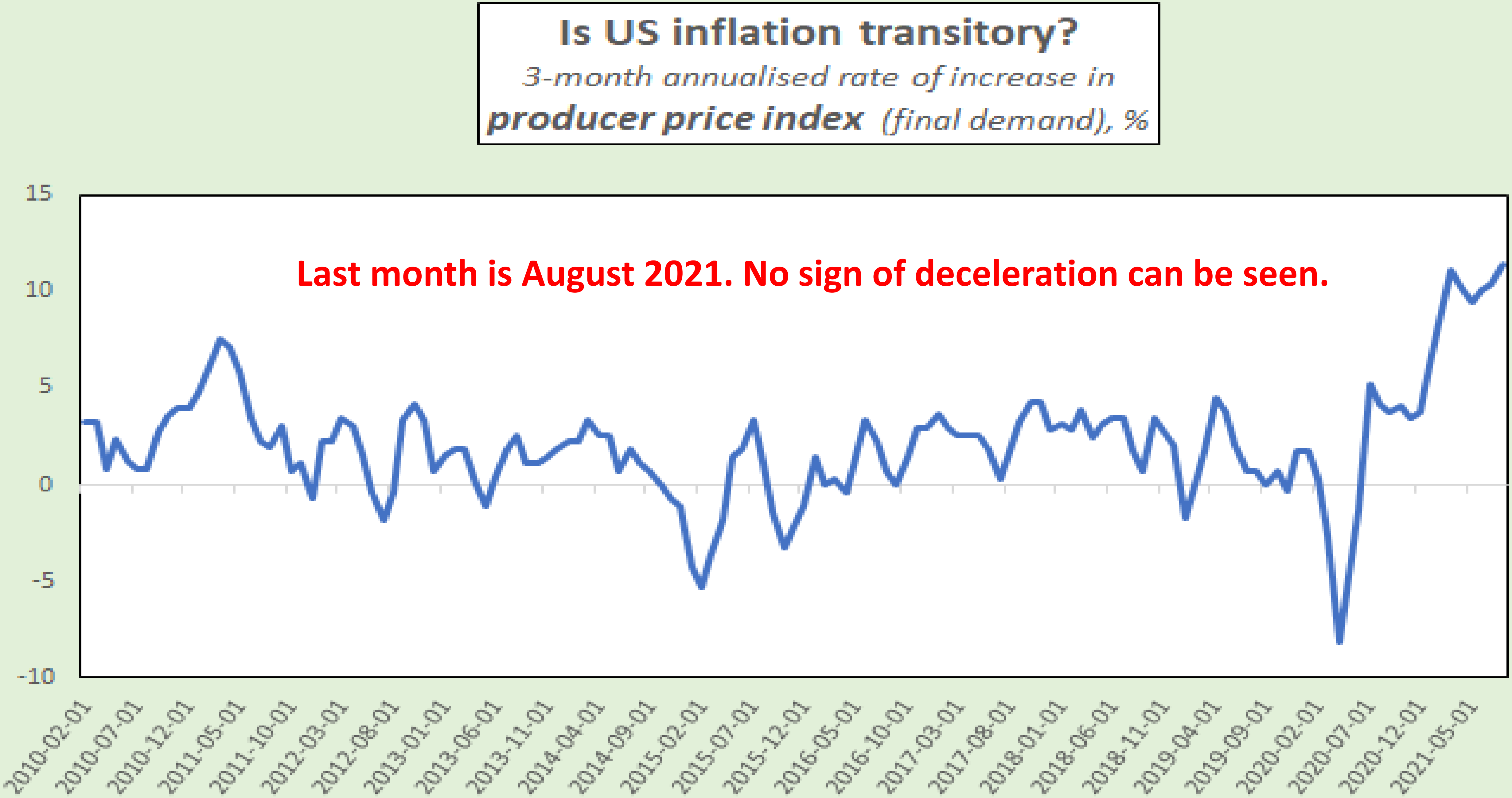
On 27 August the Bureau of Economic Affairs published its latest monthly release on consumer expenditure, with the July PCE number. The increase in the PCE deflator, using the seasonally adjusted series, from December 2020 to July 2021 was 3.2%.

Table 9.--Price Indexes for Personal Consumption Expenditures: Level and Percent Change from Preceding Period (Months)

Line		2020	2021						
		Dec.	Jan.	Feb.	March	April [r]	May [r]	June [r]	July [p]
		Chain-type price indexes (2012=100), seasonally adjusted							
1	**Personal consumption expenditures (PCE)**	**112.220**	**112.570**	**112.878**	**113.518**	**114.166**	**114.774**	**115.385**	**115.860**

Is the FOMC thinking at all?

The Fed staff's view on US inflation this year, at 28 July, could turn out correct – given the numbers published a mere one month later – **if there are no increases in consumer prices whatsoever in the last five months of the year…!!!**


Is US inflation transitory?
3-month annualised rate of increase in
producer price index (final demand), %
Last month is August 2021. No sign of deceleration can be seen.
15
10
5
0
-5
-10
2010-02-01
2010-07-01
2010-12-01
2011-05-01
2011-10-01
2012-03-01
2012-08-01
2013-01-01
2013-06-01
2013-11-01
2014-04-01
2014-09-01
2015-02-01
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2017-08-01
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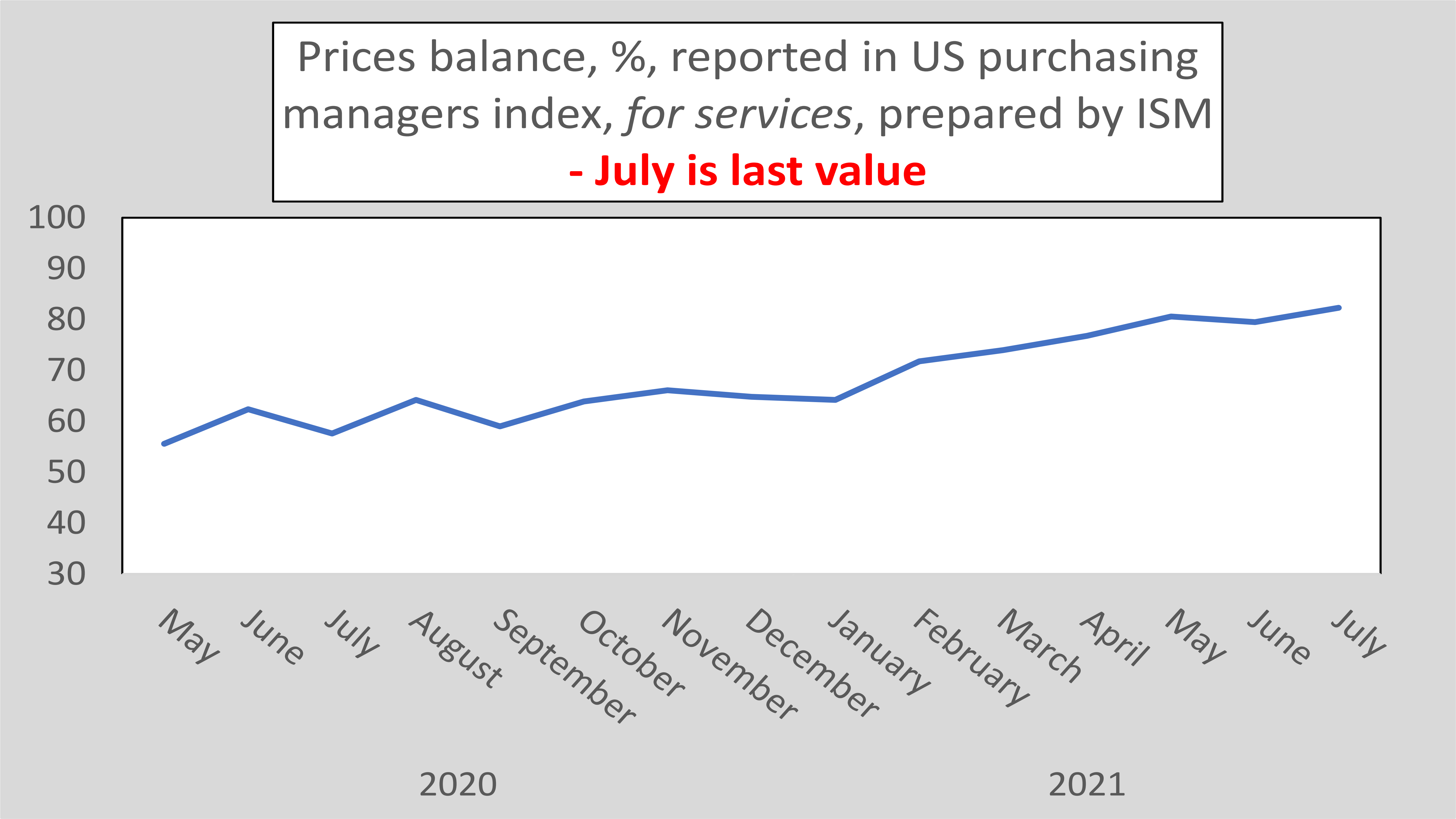
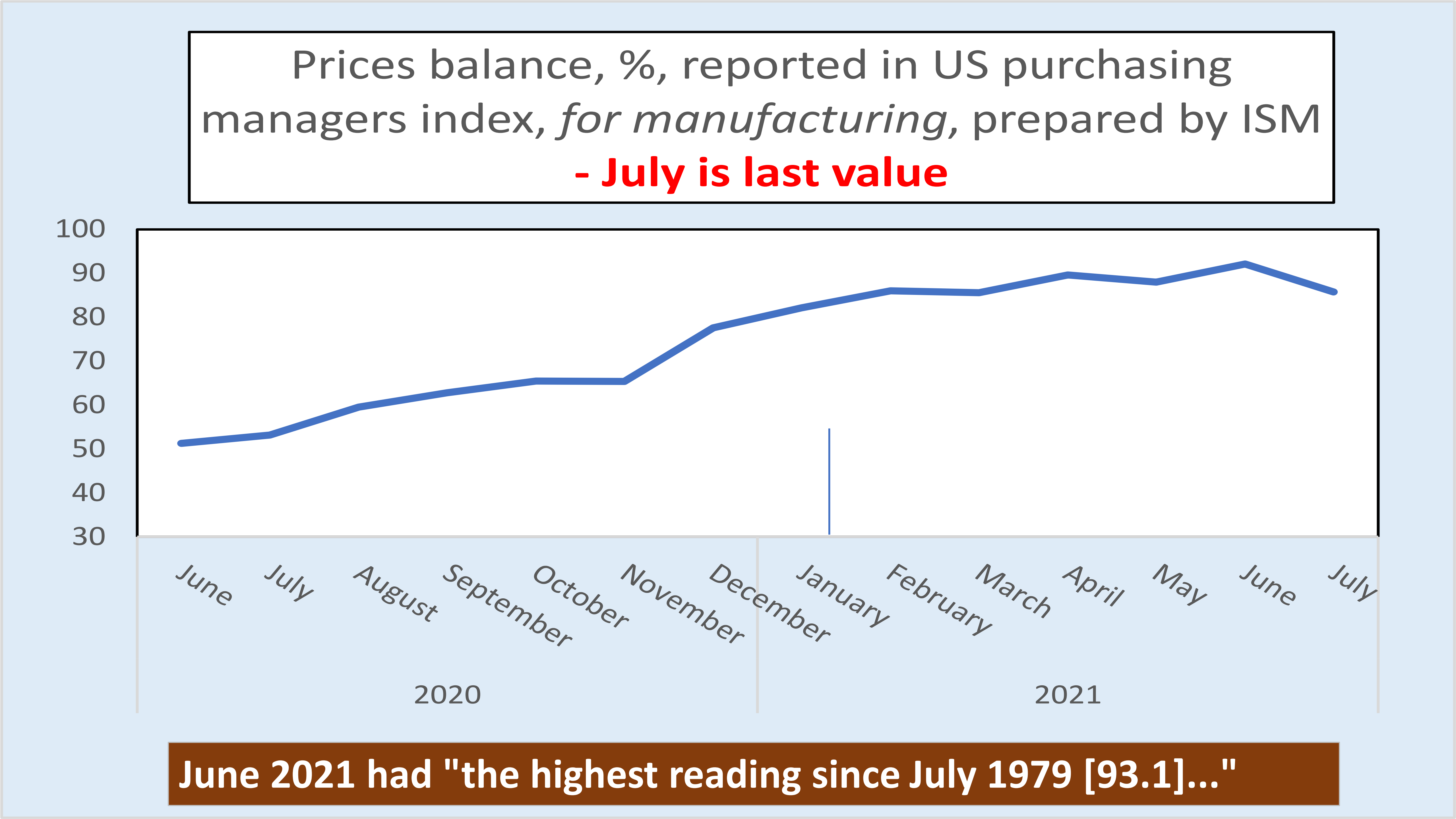
2021-05-01


Prices balance, %, reported in US purchasing managers index, *for services*, prepared by ISM
- July is last value
100
90
80
70
60
50
40
30
May
June
July
August
September
October
November
December
January
February
March
April
May
June
July
2020
2021


Prices balance, %, reported in US purchasing managers index, *for manufacturing*, prepared by ISM
- July is last value
100
90
80
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60
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40
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June
July
August
September
October
November
December
January
February
March
April
May
June
July
2020
2021
June 2021 had "the highest reading since July 1979 [93.1]..."

End-2021 projections, from the Institute of International Monetary Research

- Much does depend – even so close to the end of the year – on commodity price movements, and especially on energy price movements, which can be erratic.
- All the same, enough information is available to justify forecasts that, in the year to December 2021,

- **The increase in the US PCE deflator will be between 5 ½ % and 6%,** and
- **The increase in the US consumer price index will be between 6 ½% and 7 ½ %.**

What about 2022?

- Unless policy changes radically (with a big and early rise in interest rates) and money growth collapses, **US inflation will be higher in 2022 than in 2021**.
- **The Institute has argued this in several places, but the heart of the argument is that agents (households, companies, etc.) have a stable underlying demand to hold money balances. As a result, the velocity of money has mean-reverting properties, which imply that – over the medium term – the growth rates of money and nominal GDP are similar.**

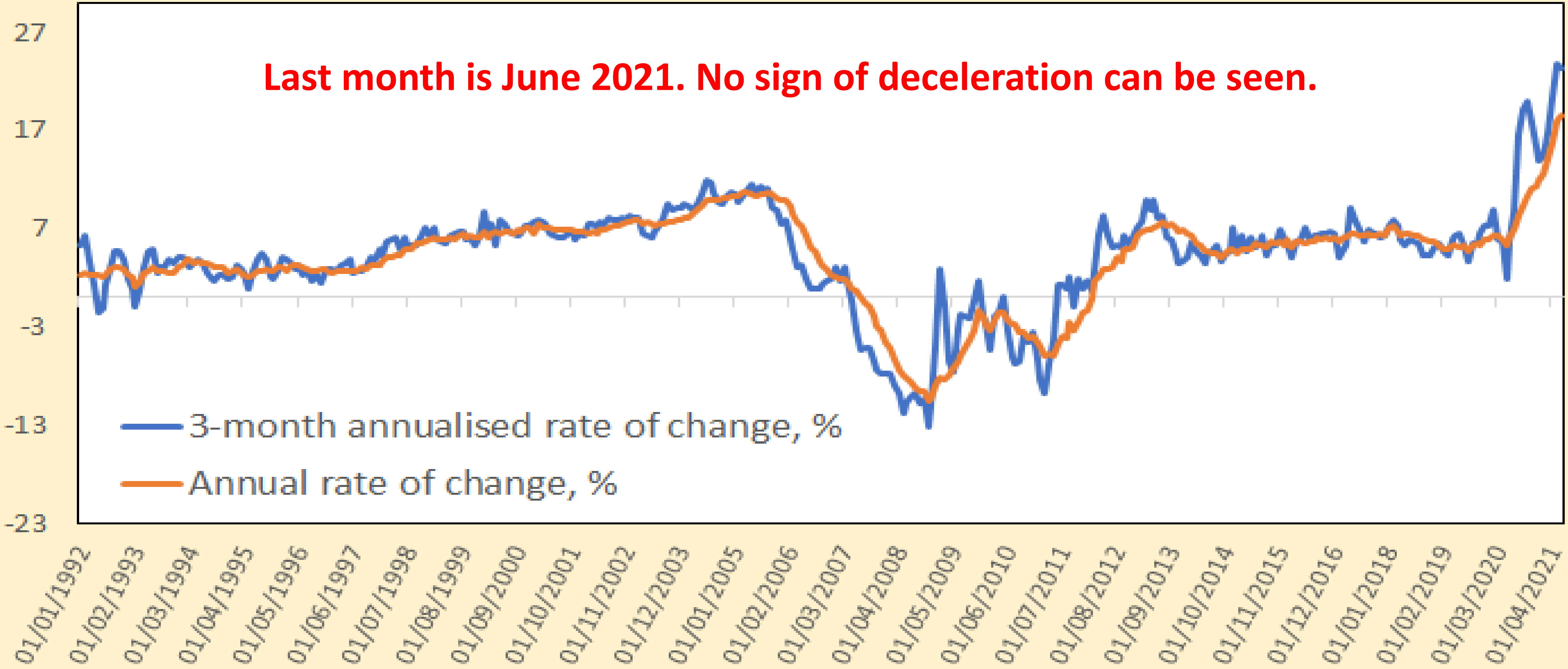
Some points in this debate

- It is preposterous to say that the marked asset price inflation now being seen in the USA is due to bottlenecks and supply shortages. **Are bottlenecks and supply shortages responsible for the bull market in tech stocks?**
- Moreover, if bottlenecks and supply shortages were the entire explanation for rising inflation, why is inflation lower in Europe than in the USA? And lower in Japan than in either?

Is US inflation transitory?

*Changes in purchase-only **house price index**, monthly data*

Source: Federal Finance Housing Agency



Is US inflation transitory?

S&P 500 index over the last five years

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...**

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But – given that the return to normalcy will be accompanied by bottlenecks and supply shortages, and given also that the current energy price slump may give way to an energy price surge – an inflation figure of over 10% would be a logical associate of an annual rate of money growth of between 15% and 20%. - *(So bottlenecks and supply shortages were mentioned in our research almost 18 months ago.)*