Why was I right about inflation in the early 2020s? 2. : The quantity-theory-of-money approach vs. interest-rate-only macroeconomics

A presentation by Professor Tim Congdon CBE,

Chair of the Institute of International Monetary Research,

in June 2024

My new book from the Institute of Economic Affairs

- One of the puzzles about the early 2020s is the almost total failure of economists to predict or anticipate the inflation surge of late 2021 and 2022.
- I was unusual in that, by noticing an explosion of broad money growth in spring 2020 in virtually all the leading developed economies (with only Japan and Switzerland being partial exceptions), I forecast the inflation flare-up ***in spring 2020***. (My earliest warnings were in late March and early April, as the money explosion started to emerge.)
- In *The Quantity Theory of Money: a New Restatement* I spend some time trying to understand why 'the profession' was so badly wrong.

My new book from the Institute of Economic Affairs

- In the book I highlighted two problems,

- Imprecision and ambiguity in the approach of those economists who do pay attention – and have paid attention – to money aggregates in macroeconomic analysis. Some of them see the key aggregate as the **monetary base**; others focus on **narrow money;** and the rest on **broad money**.

- The important role of economists who do not look at *any* money aggregate in macroeconomic analysis. They instead view monetary policy as defined entirely by interest rates, and think in terms of **interest-rate-only macroeconomics, notably three-equation New Keynesianism**.

- In last month's video I differentiated 'monetary base monetarism' and 'narrow money monetarism' from 'broad money monetarism', and emphasized **my commitment to broad money monetarism.**
- 'Monetary base monetarism' and 'narrow money monetarism' associated with monetary economics as taught at the University of Chicago in the mid- and late 20^{th} century, and with in particular Milton Friedman.
- In my view monetary base monetarism and narrow money monetarism have led to bad forecasting mistakes, and Chicago School monetarism is dead. As far as I can judge, this assertion is not particularly controversial.

- **In this month's video my concern is rather with interest-rate-only macroeconomics, which has flourished in central bank research in the 21st century.**
- Two influential pieces of work were

- A 1999 article in *The Journal of Economic Literature* by Richard Clarida, Jordi Galí and Mark Gertler entitled 'The science of monetary policy: a New Keynesian perspective'.
- A 2003 book on *Interest and Prices* by Michael Woodford, sometimes described as 'the bible of central banking'.

- The 1999 article discusses the determination of inflation in an economy without explicit mention of commercial banks and a deposit-dominated quantity of money. Woodford's book says that the path of inflation can be explained without referring to the quantity of money. (Incidentally, he tends to equate the quantity of money with the monetary base.)

My new book from the Institute of Economic Affairs

- In the book I quoted Silvana Tenreyro, an external member of the Bank of England’s Monetary Policy Committee from 2017 to 2023, who in an April 2023 speech said that she saw it as her job

“to make clearer the similarities between [central bank operations meant to affect bond yields, but which might increase the quantity of money] and Bank Rate, and avoid the impression that there is an independent ‘money’ channel of [such operations]”.

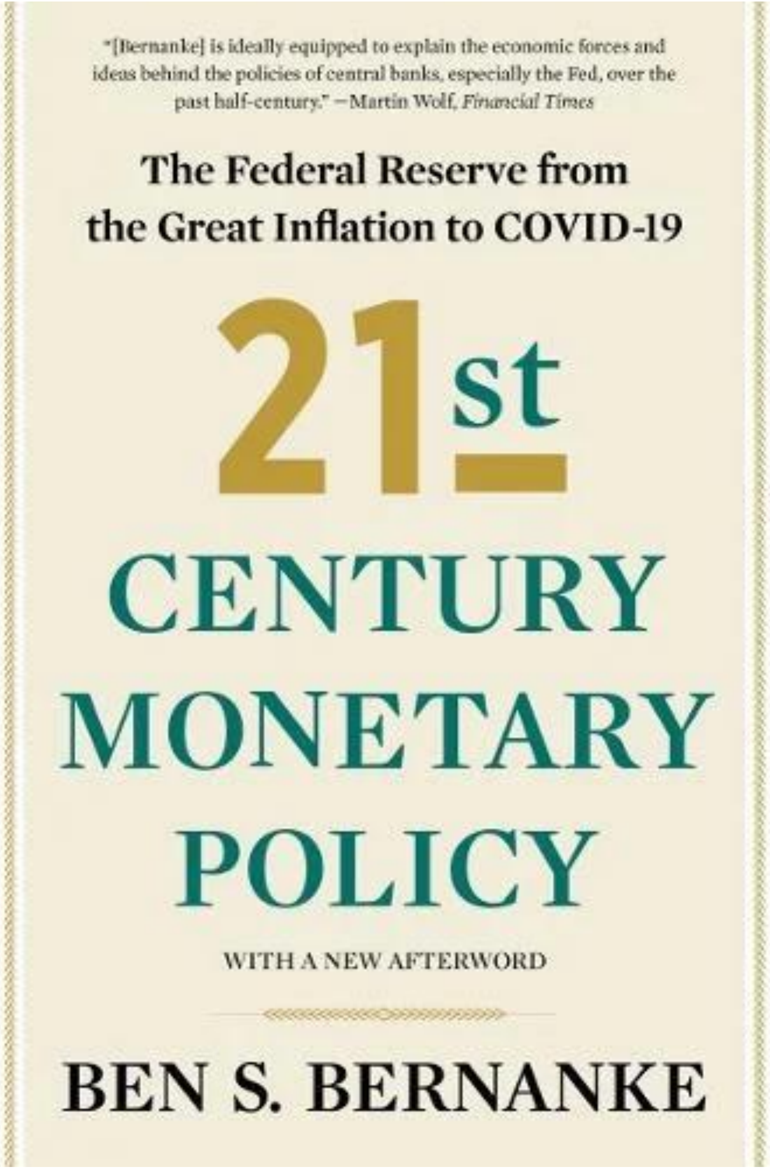
My new book from the Institute of Economic Affairs

- Tenreyro also said in that speech,

"QE affects the economy only to the extent it affects interest rates. There is no separate 'money' channel that can unleash inflation."

(It is clear from the context that "interest rates" here means **bond yields** as well as the central bank rate.)

In making her statements Tenreyro was in very good company. In his 2022 book on *21st Century Monetary Policy* Ben Bernanke said that ‘quantitative easing’ – which undoubtedly affects the quantity of money – could be seen, in its effects on the economy, as equivalent to an interest rate reduction…and the discussion could then proceed in terms of interest-rate-only macroeconomics.



Is monetary policy entirely about 'Bank rate'?

- **CERTAINLY NOT. Consider a simple sequence of transactions.**
- The UK's central bank, the Bank of England, can hold a deposit at a commercial bank, but – unlike a deposit held by a private agent like a household or a company – this is not party of the quantity of money, as usually defined.
- The Bank of England can create new deposits for itself by requesting a facility from the big clearing banks and paying for the deposits by adding to the cash reserves which the clearing banks maintain with it.

Is monetary policy entirely about ‘Bank rate’?

- The Bank of England can create new deposits for itself by requesting a facility from the big clearing banks and paying for the deposits by adding to the cash reserves which the banks maintain with it. (Where does the money come from? It comes out of thin air.)
- Alchemy? Identical sums are added to both sides of the clearing bank balance sheets.
- **The Bank of England then uses its new deposit to buy something – *indeed, anything* – from households and companies who and which constitute the non-bank private sector. Their bank deposits increase. These new deposits affect the behaviour of the households and companies, and are part of the quantity of money.**

Is monetary policy entirely about 'Bank rate'?

- Now comes the punchline.
- **This process of money creation can occur whatever the level of Bank rate.** Sure, nowadays they tend to accompany a roughly zero central bank rate.
- But in the past similar operations – operations which affect the quantity of money – have occurred with the official central bank rate in the high single digits or even in the teens.
- The essence of the operations is the purchase of something from non-bank private sector agents…

Let’s return to one of the Tenreyro statements....

My new book from the Institute of Economic Affairs

- Tenreyro also said in that speech,

“QE affects the economy only to the extent it affects interest rates. There is no separate ‘money’ channel that can unleash inflation.”

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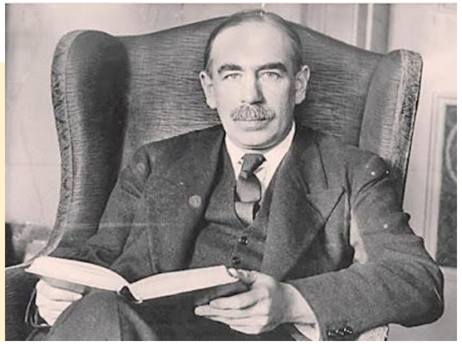
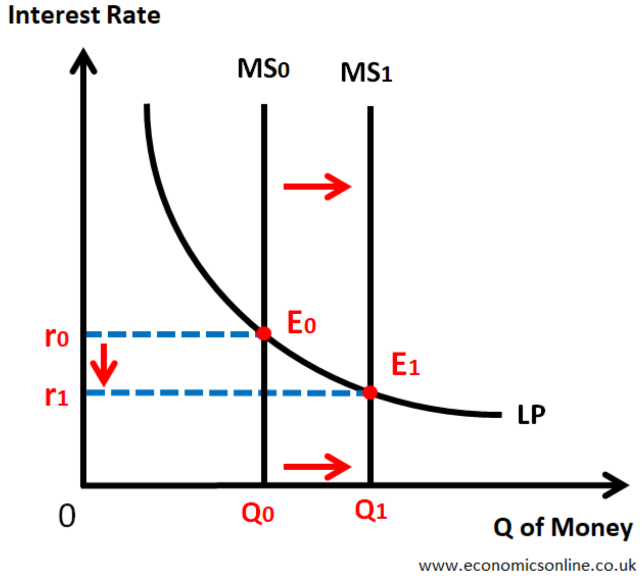
Tenreyro echoes Keynes:

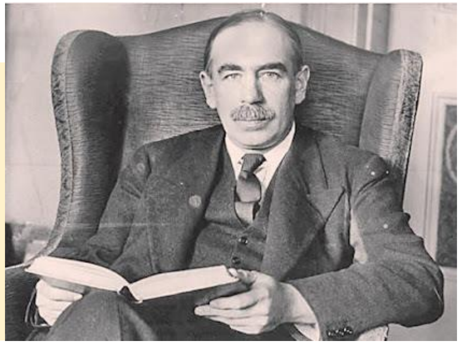


- Tenreyro appeals, implicitly, to Keynes' "liquidity preference theory of 'the rate of interest' in the sense of 'the bond yield'", to which Keynes devoted several chapters in his 1936 *General Theory*. Standard textbooks have a diagram illustrating the liquidity preference theory, which shows the relationship between the quantity of money and 'the rate of interest':

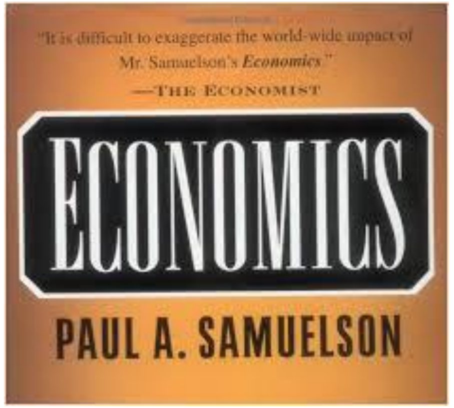


With thanks to www.economicsonline.co.uk for the chart.

Tenreyro echoes Keynes (and Samuelson):



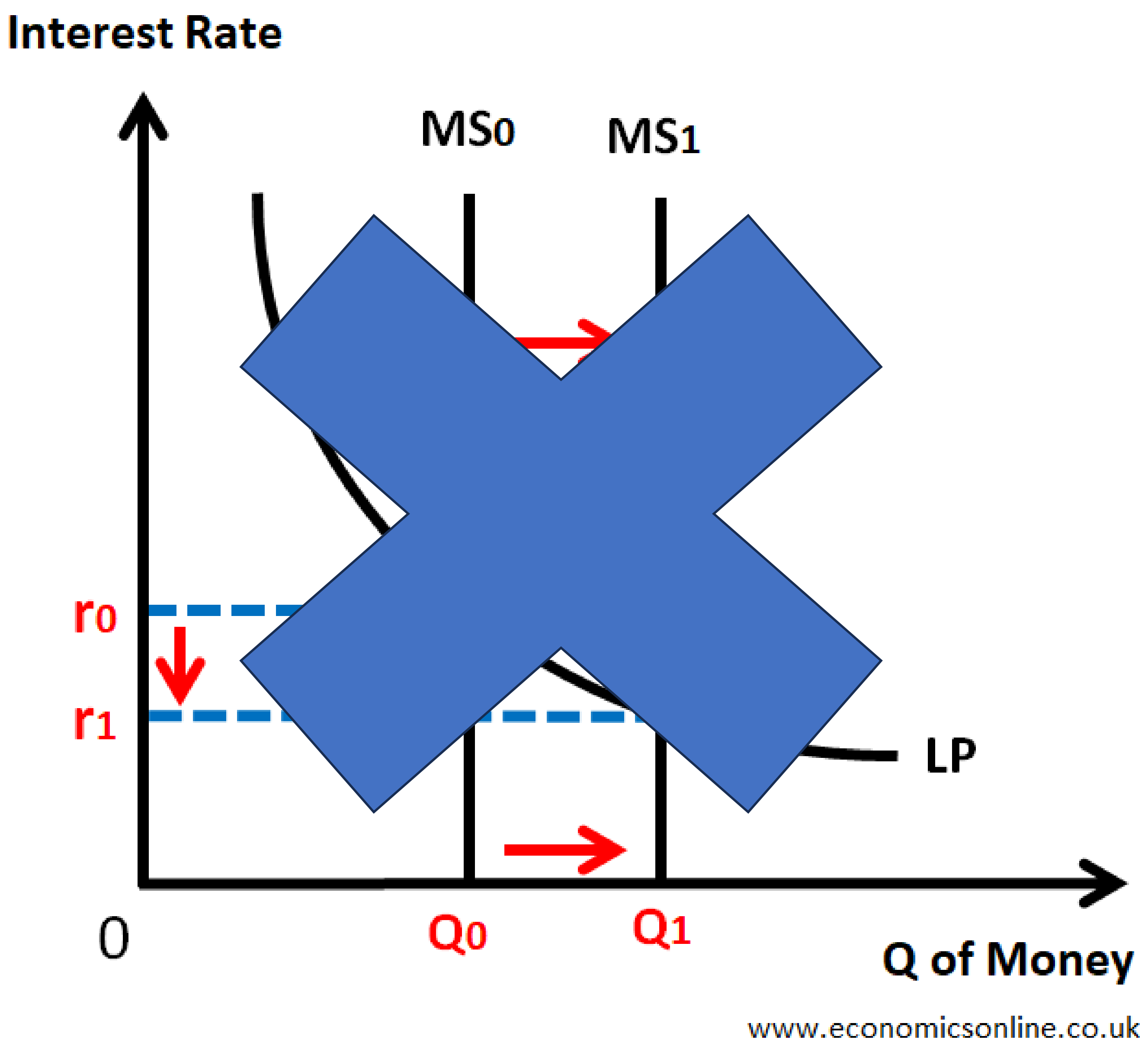
- Ultimately the authority for Tenreyro's statement - **"QE affects the economy only to the extent it affects interest rates. There is no separate 'money' channel that can unleash inflation."** – is in fact John Maynard Keynes.
- **Literally thousands of economists – probably indeed the overwhelming majority of "the profession" – think like this.** They have been heavily influenced by Samuelson's famous textbook *Economics*, which went into 19 editions…



A very bad habit in the economics profession

- Keynes devoted many pages of his *General Theory* to his 'liquidity preference theory of "the rate of interest", in the sense of "the bond yield"', i.e., the yield on fixed-interest securities.
- **In fact, his emphasis on this theory was so strong that many economists came to believe that this was the only – yes, the only – channel of influence from the quantity of money, or changes in that quantity, onto the economy.**
- The notion was then formalized and expressed in **the so-called "IS function"**, a relationship between income (Y), which was a stable multiple of investment (I), always equal to savings (S) in equilibrium *by assumption*, with investment responsive to the bond yield (r) , or – in short – $Y = f(r)$, with income and the bond yield both in real terms.

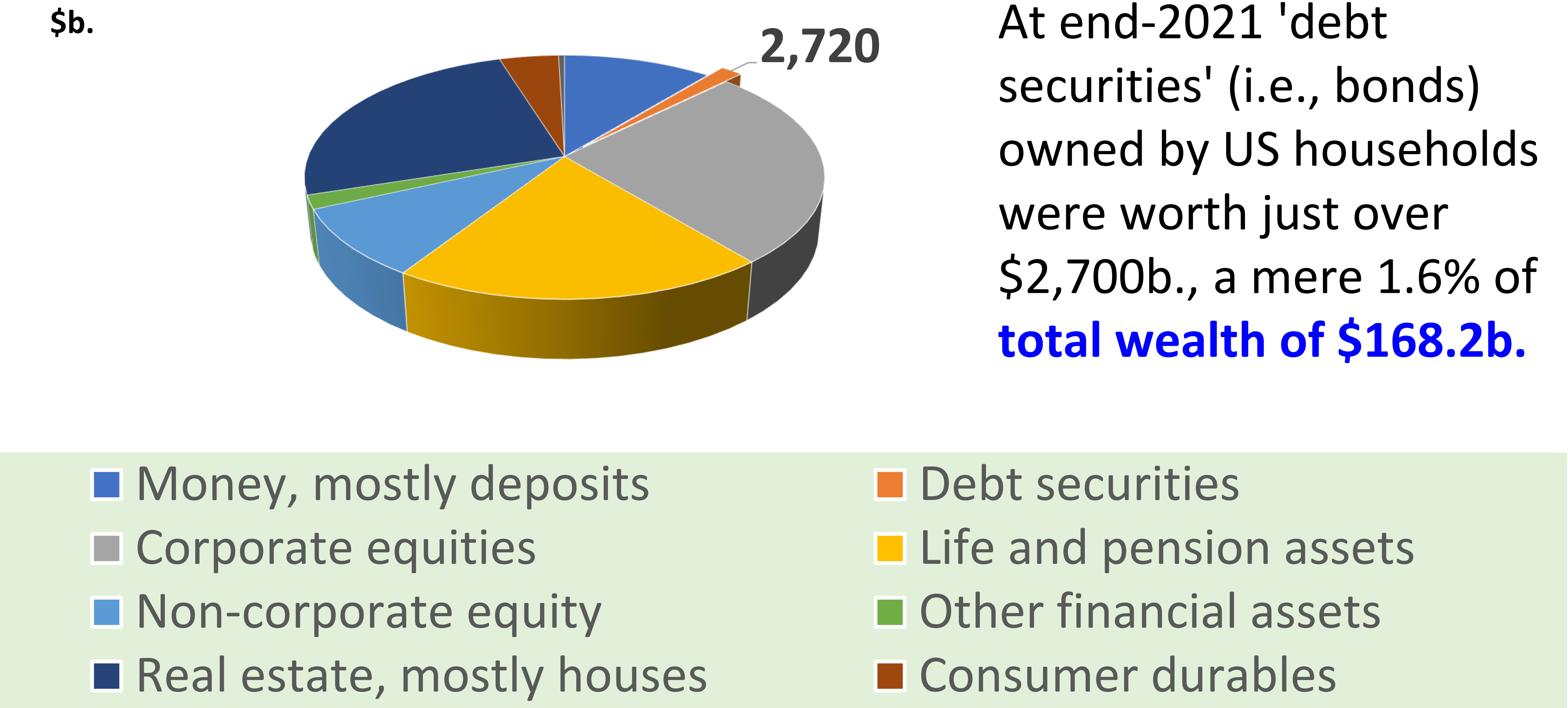
But there is a problem, a very big problem.



Portfolio choice is not only about the choice between money and bonds

- In their portfolios, households – and indeed financial institutions – are balancing money against a range of assets, including crucially corporate equity and real estate/property, notably in the form of houses.
- **PLEASE, if changes in the quantity of money can affect the price of and yield on bonds, they can also affect the price of and yield on shares on the stock market, and houses in town and country. To deny this is obviously absurd.** (In fact, very few households own bonds…)

- (And Keynes – who was an adventurous, risk-taking investor, mostly in equities – knew this very well.)



At end-2021 'debt securities' (i.e., bonds) owned by US households were worth just over $2,700b., a mere 1.6% of **total wealth of $168.2b.**

Capital gains and losses on variable-income assets in the USA's Covid period

Net holding gains (in billions of $s) from:

	Real estate	*Corporate equities*	*Mutual fund shares*	*Equity in non-corporate business*	***Selected variable-income assets in total***
2020:Q1	633	-4,798	-1,593	264	**-5,494**
2020:Q2	610	3,518	1,223	68	**5,419**
2020:Q3	722	1,768	532	294	**3,316**
2020:Q4	983	3,847	977	418	**6,226**
2021:Q1	1,243	1,800	332	483	**3,857**
2021:Q2	1,759	1,769	587	663	**4,779**
2021:Q3	1,887	188	-83	864	**2,856**
2021:Q4	770	1,278	446	596	**3,089**
2022:Q1	3,303	-1,018	-804	568	**2,049**
2022:Q2	2,135	-5,108	-1,493	673	**-3,794**
2022:Q3	-1,254	-1,016	-557	209	**-2,618**
2022:Q4	-978	1,182	534	-197	**541**

Personal disposable income was $16,388.6 billion in 2019 and $18,523.6 billion in 2022.

In the first quarter of 2020 – as the medical emergency began – US households suffered capital losses of almost $5.5 trillion, nearly all on equities; in the next eight quarters they enjoyed total capital gains of almost $32 trillion, much more than one year's disposable income. The gains were from both the stock market and houses - then in Q2 2022 M3 broad money started to fall.

Capital gains and losses on major asset classes in the USA's Covid period

Net holding gains (in billions of $s) from:

	Selected variable-income assets in total	Debt securities	*Change in value of variable-income assets as multiple of that in value of debt securities, without regard to sign*
2020:Q1	**-5,494**	**121.3**	*45*
2020:Q2	**5,419**	**51.9**	*104*
2020:Q3	**3,316**	**-2.0**	*1,638*
2020:Q4	**6,226**	**5.2**	*1,205*
2021:Q1	**3,857**	**-121.9**	*32*
2021:Q2	**4,779**	**36.5**	*131*
2021:Q3	**2,856**	**-31.7**	*90*
2021:Q4	**3,089**	**-4.5**	*685*
2022:Q1	**2,049**	**-200.2**	*10*
2022:Q2	**-3,794**	**-122.0**	*31*
2022:Q3	**-2,618**	**-144.8**	*18*
2022:Q4	**541**	**53.6**	*10*

- Tenreyro also said in that speech,

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During the Covid-affected period excess money balances drove asset price gains in US equities and houses which dwarfed anything in bond yields. Anyhow bond yields were *higher* at the end of Covid than at the start, despite the money injection.

Be sceptical about ‘the economics profession’ – and of **its claims to scientific status and modernity**

- **The Science of Monetary Policy: A New Keynesian Perspective**
- Richard Clarida, Jordi Gali and Mark Gertler

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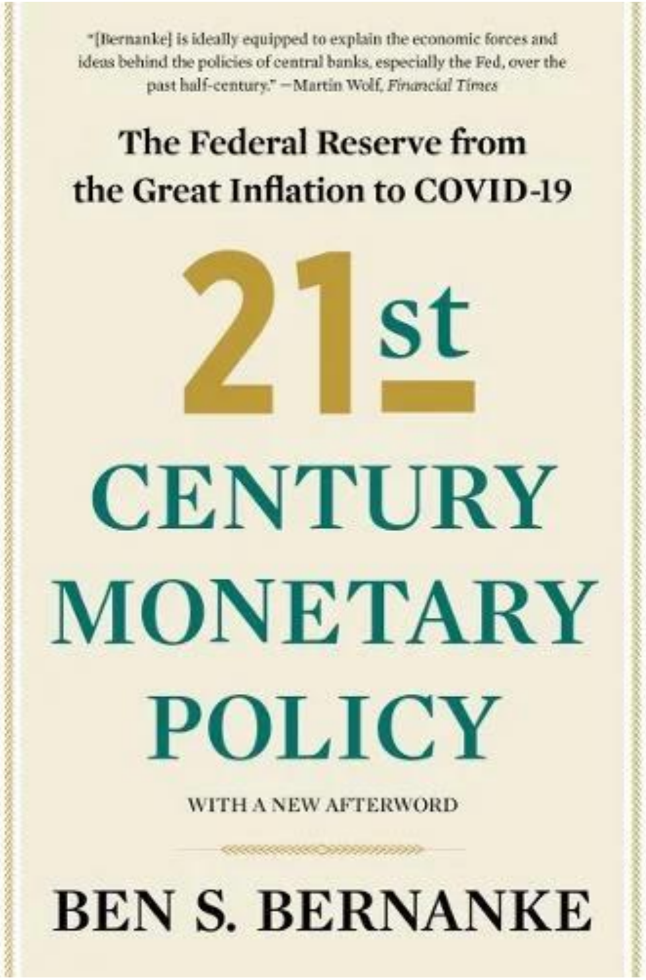
(pp. 1661–1707)



My new book from the Institute of Economic Affairs

- One of the puzzles about the early 2020s is the almost total failure of economists to predict or anticipate the inflation surge of late 2021 and 2022.
- Note that other economists – often unsympathetic to the quantity theory of money – have realized that something was wrong. Jason Furman, a Harvard economist who advised President Obama, in a January 2022 piece on the Project Syndicate website lamented the economics profession's

"dismal performance" and
"collective failure"

in not forecasting inflation correctly.