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High Inflation Will End Soon

But the Fed's change in course heightens the risk of recession.

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1:19 pm ET



A shopper in a Whole Foods Market supermarket in New York, Dec. 14, 2022.

PHOTO: RICHARD B. LEVINE/ZUMA PRESS

We predicted two years ago that inflation would be persistent and rise to the highest levels in a generation. We were right when others weren't because we based our forecast on the quantity theory of money, which links asset prices, economic activity and inflation to changes in the money supply. Despite this week's increase in monthly inflation, we now think inflation is knocking on death's door and a recession may be on the way.

The dramatic change in our predictions is due to the Fed's dramatic change in behavior. In March 2020, the central bank embarked on large-scale asset purchases, which immediately and dramatically accelerated broad money growth. In May 2020, the three-month annualized growth rate of the money supply, as measured by M2, reached 77.2%. By March 2022, M2 had increased by an unprecedented cumulative 41%. Even during the inflation crises of 1973-75 and 1980-82, the increase in money growth didn't approach what occurred in 2020-21.

Inflation usually lags sustained changes in the money supply by 12 to 24 months. Sure enough, by April 2021, headline inflation had increased to 4.2% from 1.5% in March 2020. By March 2022, it was 8.5%.

Given these data, we extended our forecast in the summer of 2022, writing that year-over-year inflation would end 2022 at 6% to 8% and would fall to 5% by the end of 2023. Excess money balances, which resulted from unbridled money growth in 2020-21, were some 20% greater in the second quarter of 2022 than the multidecade trend line for M2. We assumed that households and firms would spend these excess balances gradually until they hit “normal,” or on trend, and so inflation would persist.

Instead, the Fed reversed course sharply and households and businesses quickly shed excess money. M2 peaked at \$21,739.7 billion in March 2022, and since then has declined to \$21,207.4 billion. In the past nine months, M2 has declined at an annualized rate of 3.2%. This flip from expansion to contraction is the steepest adjustment in money-supply growth in postwar U.S. history. Based on 2022’s fourth-quarter data, the excess money balances have already declined to only 11.8% greater than normal and that slight bump could dissipate entirely by mid-2023. In other words, we’re almost out of the inflation woods.

Yet the Fed seems unlikely to ease off contractionary policies—in part because the central bank wrongly focuses on the Phillips curve, which portrays inflation and unemployment as contrary forces. Seeing a tight labor market, the Fed says it anticipates upward inflation pressures to persist through 2023, so quantitative tightening and high interest rates will remain in place until further notice. Given that, we are lowering our forecast for the year-over-year inflation rate from 5% to between 2% and 5% at the end of 2023.

If the Fed doesn’t adjust to this reality, it will greatly increase the chances of a recession in 2023.

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