Upside Down Explanations of Inflation

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The April, May and June figures for US CPI inflation were a major shock both to markets and to Federal Reserve officials. The figures for the overall headline index in each month increased by 0.8%, 0.6% and 0.9% respectively, raising the year-on-year figure for June to 5.4%, the highest rate since September 1990. Similarly, the core PCE rate was 3.5% on a year-to-year basis for June compared with the Fed's target rate of 2%.

Nevertheless, after steep increases in the period to the end of March, 10-year US Treasury bond yields have generally fallen since then (from 1.74% to 1.30%), suggesting that market participants are not too concerned about inflation. How can this be?

Time and again we hear officials from the Federal Reserve explaining the current episode of inflation as "transitory". They mean that the elevated rate of inflation is not going to be long-lasting, and that it will fall back to 2% in a matter of months. As Fed Vice Chair Richard Clarida explained in a Q&A session following a speech on August 4[1], the current high rate of inflation reflects two temporary, idiosyncratic elements that will disappear soon: (1) a "round-trip rebound of prices" from low levels in spring and summer 2020 (such as hotel prices that were cut at the onset of the pandemic and are now being re-priced upwards, leaving prices not much changed overall), and (2) a similar phenomenon at the global level driving up commodity prices.

Another possible source of inflation, according to Mr Clarida, may come from the labour market, but he admits this is hard to estimate as he expects the participation rate to rise during the autumn (for example as people presently doing child-care return to the labour force), increasing the supply of labour. In fact, he argued, "there is significant downside risk to this forecast".

Moreover, as long as inflation expectations remain anchored at a low level, Fed officials repeatedly say that they are confident there will be no serious threat to price stability.

As far as the bond market is concerned, the Fed is winning the propaganda war.

But is it true that inflation is due to a range of such idiosyncratic factors? What is really behind the sudden surge in the inflation rate?

Stephen Roach, a faculty member at Yale University and formerly chairman of Morgan Stanley Asia, tells a sobering story about how he worked for Chairman Arthur Burns at the Fed in the 1970s.[2] He "was witness to the birth of the Great Inflation as a Fed insider". Burns was an expert on the business cycle and used his "knowledge to poke holes in staff presentations". Roach "found quickly that you couldn't tell him anything".

[1] https://www.piie.com/events/fed-vice-chair-richard-h-clarida-us-economic-outlook-and-monetary-policy
[2] https://facts-and-arts.eu/current-affairs/ghost-arthur-burns

"Yet Burns, who ruled the Fed with an iron fist, lacked an analytical framework to assess the interplay between the real economy and inflation, and how that relationship was connected to monetary policy. As a data junkie, he was prone to segment the problems he faced as a policymaker, especially the emergence of what would soon become the Great Inflation. Like business cycles, he believed price trends were heavily influenced by idiosyncratic, or exogenous, factors – "noise" that had nothing to do with monetary policy."

"This was a blunder of epic proportions. When US oil prices quadrupled following the OPEC oil embargo in the aftermath of the 1973 Yom Kippur War, Burns argued that, since this had nothing to do with monetary policy, the Fed should exclude oil and energy-related products (such as home heating oil and electricity) from the consumer price index. The staff protested, arguing that it made no sense to ignore such important items, especially because they had a weight of over 11% in the CPI."

"Then came surging food prices, which Burns surmised in 1973 were traceable to unusual weather – specifically, an El Niño event that had decimated Peruvian anchovies in 1972. He insisted that this was the source of rising fertilizer and feedstock prices, in turn driving up beef, poultry, and pork prices. Like good soldiers, we gulped and followed his order to take food – which had a weight of 25% – out of the CPI."

"By the time Burns was done, only about 35% of the CPI was left – and it was rising at a double-digit rate! Only at that point, in 1975, did Burns concede – far too late – that the United States had an inflation problem. The painful lesson: ignore so-called transitory factors at great peril."

Today Fed governors and White House staffers are making the same type of error. Those of us who believe that inflation is a monetary phenomenon have watched with astonishment as the Fed has allowed the US M2 money supply to be inflated by almost 32% since February 2020.

One of the best recent explanations of the process of inflation has been given by Albert Friedberg, a money manager and commodity trader from Toronto.[3] Inflation, he says, is inevitably "lumpy".

"Excess money creation leads to rising prices. As a consequence, goods and services that are in adequate supply will rise in price less than those not in adequate supply or will not rise at all. Excess money allows the price of hard-to-find goods to rise far faster than the price of easily found goods without necessitating any price accommodation."

"During the last major episode of intense inflation, the decade of the seventies, the price of oil tripled thanks to supply restrictions (whether artificial or not is not relevant to this discussion). Such a large rise in prices in a key commodity should have caused an immediate liquidation of non-oil commodities. After all, if consumers had to spend more money at the pump, by necessity they had less money to spend on other consumer goods.

[3] http://www.friedberg.ca/wp-content/uploads/2021/07/FMG_Q2_2021_v2.pdf (pp. 6-8)

"The tripling of oil prices should have represented nothing more than a relative price increase — relative to other items, oil became more expensive. But this is not exactly what happened. Consumers were able to "accommodate" the rise at the pump because they had more money to spend. ***So the relative price adjustment took place but took much longer to occur.*** And the overall price level rose, led by oil but accompanied by other goods and services, which rose "merely" a bit. [Emphasis added.]

"In time, overall demand, driven by excess money creation, spilled over into other goods that gradually came into short supply. First cocoa (remember how chocolate bars got smaller but the price stayed the same?), then sugar, then wheat, and so on. This is how inflation works — not in a smooth, straight line, but in a lumpy fashion. This is a simplistic explanation but should suffice to explain our present predicament."

Take the price of US single-family homes today. These are in short supply and their prices have been rising at 25% p.a. recently. Other prices have "accommodated" them by remaining quiescent for the most part. The higher prices are needed to entice builders to create new supply, but in time these higher prices will spill over into rents and other prices that have not yet impacted the CPI.

Similarly for other goods and services in short supply such as cars, international shipping rates, electronic chips etc. Since these have surged without other prices adjusting downwards, this must mean that higher inflation is here to stay – at least for the next two years while the excess money works its way through the system.

As Friedberg concludes, "The foolish "segmentation" argument adduced by otherwise intelligent people will begin to resemble a game of whack-a-mole. Fed officials stated [this week] that they will be ready to tackle inflation whenever they feel that it ought to be done. But that's a fiction. To deal with inflation, they first need to understand what's causing it. Only then, and that could be months or years away, will they understand what needs to be done."

"It's useless for us to speculate any further. It will be a long time, measured in years, before the Fed regains control of prices. During this long period of time, inflation will rage and consumer purchasing power will shrink as wages struggle to keep up with prices. Economic activity will be severely affected by this loss of purchasing power, and slowdowns and recessions will follow. Corporate margins will shrink. Price controls, always useless and counterproductive, will almost certainly reappear on the scene. The evils of social inequality will be compounded, and social unrest will follow…"

Fundamentally inflation is caused by excess money, a phenomenon that central banks have deliberately re-created after a decade or more of restraint. Inflation in this sense is a top-down process – money driving individual prices higher in a somewhat random, chaotic order determined by which goods and services happen to be in short supply. However, the overall process is one in which excess money eventually pushes all prices higher.

Contrary to what we are told by central bankers, the current inflation is not a transitory, bottom-up, accidental process delivered by temporary, idiosyncratic or segmented price increases -- associated with the re-opening of economies -- which will soon be reversed. Central bankers are following an upside down theory of inflation.

Investors, especially bond investors, should be very wary of maintaining exposure to any assets that are vulnerable to inflation at a time when rising inflation is likely to erode returns for at least the next two years.