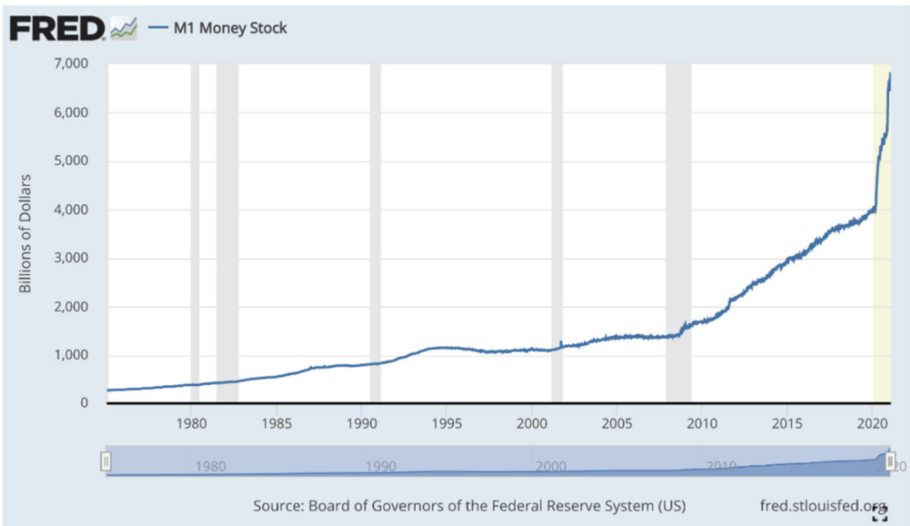
Monetarism at a Crossroads

November 15, 2021

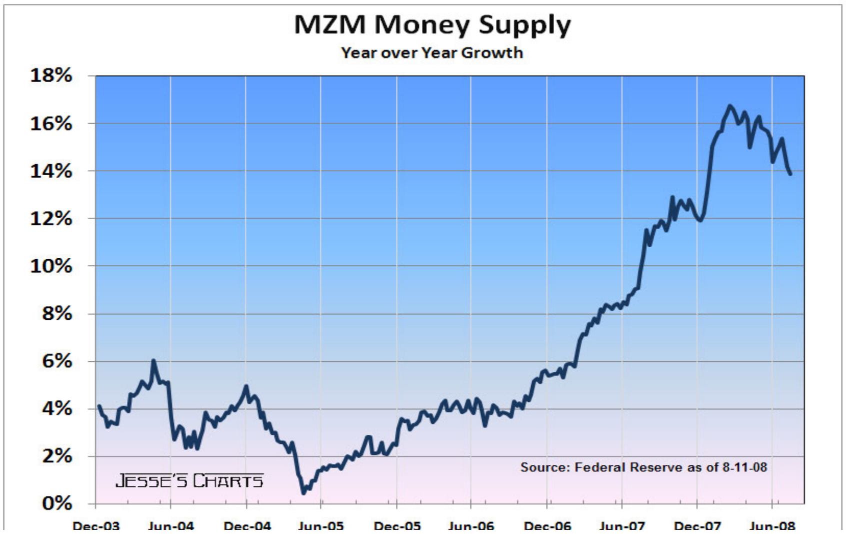
Recent articles in financial publications have linked the recent surge in inflation to the Fed's safety-net policy of providing "money" by maintaining record low interest rates and extensive bond buying of both government and mortgage securities. These actions have resulted in a record surge in the money supply as reflected in the exhibit below.



Monetarists looking at this acceleration in money supply see that hyperinflation is right around the corner! If ever such a relationship existed between growth in money supply and subsequent levels of inflation, then the current environment could not be better for fulfilling their expectations. However, they also tell us that it will take up to two years for such an increase in inflation to show up in the statistics.

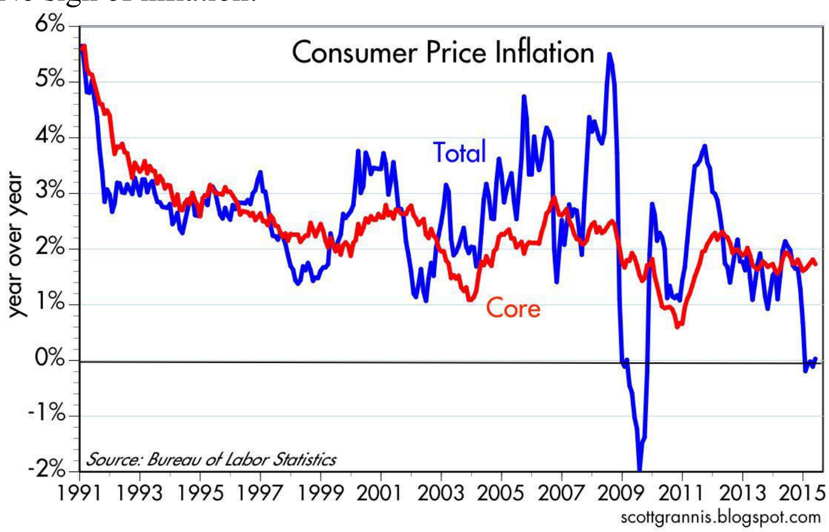
If such a relationship exists, then past experiences with surging money supply should be followed by a serious increase in inflation some two or more years after the event. One need only go back to the 2008-2009 financial crisis to find another Fed safety-net increase in the money supply to blunt the effects of the near collapse of financial markets.

The chart on the following page quantifies the surge in money supply growth mid-2006 through mid-2007, growing from a rate of about 4% to as high as 16%+ -- about a quadrupling! Such a surge in money supply can be reflected in an acceleration in the level of inflation some two to three years beyond that surge that ended in early-2008.



Fortunately, we can look back at that period to see whether that relationship existed two years out or even further out as some experts would argue that, for a variety of reasons, it will take longer for that inflationary event to take place.

The last exhibit provides a good picture of both the consumer price index (CPI) and the core CPI which is the CPI less the volatile food and energy components. While this chart reflects the volatility of the consumer price index, the core index reveals the failure of the relationship between money supply growth and inflation. From 2008 through 2015, some seven years, there was no increase in the rate of inflation. For most of that time, the core rate of inflation fluctuated between 1-2%. No sign of inflation!



Clearly the current record setting surge in the money supply may affect inflation due to the sheer magnitude of the increase. But if history is any reasonable guide as to the lack of a relationship between these two variables, then we are not in for an unusually long period of high inflation.