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Neglecting Money

The new monetary theorists are making a huge blunder.

BY TIM CONGDON

Rarely have top economic policymakers been more united than they were in their response to the coronavirus pandemic. In the leading advanced nations, governments widened budget deficits and financed the enlarged deficits mostly from banking systems, while central banks carried out extensive asset purchases in programs of so-called "quantitative easing." Writing in the *Financial Times* June 22, 2020, Gavyn Davies, former chief international economist for Goldman Sachs, opined that these highly stimulatory measures had received "a chorus of approval from the [economics] profession."

Stimulus was needed—according to the many members of the chorus—because Covid-19 was expected to lead to bankruptcies and job losses on a vast scale. Thinking in New Keynesian terms, they believed that the resulting unemployment would constrain wage and price increases over the medium term. Olivier Blanchard—chief economist at the International Monetary Fund from 2007 to 2015—judged in a May 24, 2020, blog for the Vox CEPR Policy Portal that it was hard "to see strong demand leading to inflation."

A few days earlier, Richard Clarida, vice chair of the Federal Reserve, had told the New York Association for Business Economics that, "My projection is for the Covid-19 contagion shock to be disinflationary,

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Asset prices and commodity prices signal higher inflation in a boom context as the sequel to the coronavirus pandemic.

not inflationary." Clarida must have been an important voice on the Federal Open Market Committee, since the minutes of its June 2020 meeting affirmed that "highly accommodative financial conditions" would have to be maintained "for many years" in order "to quicken meaningfully the recovery from the current severe downturn." Notice the phrase "for many years."

The unanimity of policy response and commentariat endorsement in spring 2020 was exceptional, perhaps unprecedented. But so too have been the speed and completeness of the refutation by events of the professional consensus. The first surprise was not just the resilience of asset markets, but the vigor with which stock markets and real estate values rebounded from March 2020 lows. At its highs in January 2021, the S&P 500 index was 75 percent higher than it had been less than ten months earlier. While U.S. equities led the pack, stock markets around the world also registered massive gains. Moreover, fears of tumbling real asset markets were dumbfounded. To focus on the United States again, in the six months to November 2020, the Federal Housing Finance Agency's index of house prices climbed by 8.2 percent (that is, at an annualized rate of almost 17.2 percent).

Plainly, the movements in asset prices during the Covid-19 emergency have been inflationary, not disinflationary. The prognoses made by Blanchard, Clarida, and many others in the emergency's early phase have been contradicted. Admittedly, asset prices are volatile and difficult to predict, and they may slip back in 2021. Further, no mechanical short-run relationship is to be expected between them and consumer prices. All the same, investors are constantly arbitraging between wealth in the form of corporate equity and wealth as real estate, and much econometric evidence suggests that house prices affect consumption and aggregate demand. Surely, a high rate of inflation in asset markets makes disinflation implausible at the consumer level.

A major debate is imminent.

The second shock has been a surge in commodity prices. When Covid-19 hit, and governments reacted by lockdowns and enforced social distancing, it was inevitable that tourism and transport would be severely disrupted. The logic of the connection between Covid-19 and a collapse in oil prices was soon clear, while this collapse was the main influence on falls in consumer prices in March, April, and May 2020. Here was the immediate background when Blanchard, Clarida, and other New Keynesians warned about persistent disinflation.

But the turmoil of those months had no definite message for commodity prices in the medium term, when a realistic prognosis had to be that modern medicine would bring Covid-19 under control. In their conjectures about disinflation, the New Keynesians were now-casting, not forecasting. In practice, aggregate demand in many economies was more robust in late 2020 than generally foreseen. Moreover, towards the end of the year several vaccines were reported as being effective against the virus and large-scale vaccination programs were announced. A return to medical normality seemed—and continues to seem—possible by mid- or late 2021. Some industries

Continued on page 58

Opening Pandora's Box

In short, inflation is likely in coming quarters to be embarrassingly higher than internationally renowned economists projected as recently as last spring. It was then that the crucial decisions in support of fiscal expansionism and quantitative easing were taken, to be applauded by the great, the good, and the myopic in the global policymaking fraternity. These decisions may have seemed justified at the time by emergency conditions. Nevertheless, they opened up a Pandora's box of price-raising vexation and trouble. The policy issue will increasingly be how to put the vexation and trouble back inside the box.

—T. Congdon

Continued from page 38

had run down inventories because of all the scares about disinflation and deflation. Suddenly, they confronted a very different risk, that they would be short of raw materials, components, and semi-finished products, and so unable to meet a strong recovery in demand. Commodity prices shot up as companies rebuilt inventory, in anticipation of better times ahead.

Several commodity price indices are available, but the S&P GSCI index—used in futures trading at the Chicago Mercantile Exchange—has claims to be the best. Its composition is intended to reflect the economic significance of its constituents. Thus, oil and gas are far more important in its weighting than the base metals, which is in tune with reality. In the two months to April 21, 2020, this index plunged 43 percent, reflecting above all the behavior of oil prices. But at the end of January 2021 it had risen 90 percent from the April 21 nadir. The jump in the index last autumn, particularly in the final few weeks of the year, was the largest in such a short period since the index's inception in 1991.

Commodity prices gains in the last three quarters of 2020 were a crushing rebuttal of the disinflation forecasts. Skeptics might protest that commodity prices could still go into reverse and drop sharply in early 2021. But there is a compelling reason to dismiss this notion. At present and in the next few months, vaccination will protect the vulnerable elderly from Covid-19, just as high numbers of second-wave infections confer immunity on much of the younger population. The economic sectors damaged by the pandemic will experience a big bounce-back in activity, and this bounce-back is likely to result in very high growth in aggregate demand and output in the summer and autumn. If so, that will intensify the upward pressures on commodity prices.

A high rate of inflation in asset markets makes disinflation implausible at the consumer level.

So developments on two fronts—asset prices and commodity prices—signal higher inflation in a boom context as the sequel to the coronavirus pandemic. Can anything specific be said about consumer prices? Given its salience in global economic discussion, the American situation demands particular attention and again has an unsettling message for the disinflation school. The March–May 2020 falls in consumer prices will of course leave the annual rise in the Bureau of Labor Statistics' much-watched index after twelve months have elapsed in March–May 2021. It follows that, even if consumer prices were unchanged in those three months of 2021, the annual change would rise. This is the notorious "base effect" at work.

What will happen if the monthly changes are in line with the situation before Covid-19? Remember that in the year to January 2020, the CPI rose by 2.5 percent, or at a typical monthly rate of 0.2 percent. And what sort of numbers might be envisaged if—due partly to rising input costs from the commodity price surge just analyzed—consumer prices advance by, say, a quarter of a percent more each month in 2021 than in 2020? The table shows the implications for the annual change in the U.S. CPI of both these far-from-unreasonable assumptions.

Readers can make up their own minds about what lies ahead. They will recall that at several recent press conferences Fed Chair Jay Powell has been blasé about inflation dangers. He has even said that the Fed wants to see annual inflation above the 2 percent figure over an extended period, in line with its new "average inflation

Annual increase in Consumer Price Index in 2021, for two different trajectories of the monthly increase

	0.2 percent per month increase	0.45 percent per month increase
January	1.3	1.6
February	1.5	2.0
March	2.1	2.9
April	3.1	4.1
May	3.4	4.7
June	3.0	4.6
July	2.6	4.4
August	2.4	4.5
September	2.4	4.8
October	2.6	5.2
November	2.6	5.4
December	2.4	5.5

target” framework. The table brings out two points. First, if U.S. inflation resumes its pre-Covid monthly pattern, reported annual inflation will be above 3 percent by the middle of 2021. Second, if underlying upward pressures on prices are supplemented by extra inflationary forces due to higher commodity prices, the number could approach 5 percent by mid-year and exceed it by end-year.

The New Keynesian neglect of money is to blame for the looming resurgence of inflation.

In short, inflation is likely in coming quarters to be embarrassingly higher than internationally renowned economists projected as recently as last spring. It was then that the crucial decisions in support of fiscal expansionism and quantitative easing were taken, to be applauded by the great, the good, and the myopic in the global policymaking fraternity. These decisions may have seemed justified at the time by emergency conditions. Nevertheless, they opened up a Pandora’s box of price-raising vexation and trouble. The policy issue will increasingly be how to put the vexation and trouble back inside the box.

The key argument is that monetary financing of large budget deficits, combined with central bank asset purchases, resulted in unusually fast monetary growth. Everywhere in the advanced nations, the annual increase in the quantity of money was the highest last year for over a decade and, even more remarkably, in some countries it was the highest for many decades. The United States was egregious in this respect. In April—when the pump-priming was at its most frenetic—the broadly defined M3 aggregate went up almost $1.7 trillion, or by 7.7 percent. It must be emphasized that this was not the increase in the year to April, but the increase in the one month of April. That increase in one month was in fact larger than in any previous full year in the 2010s! For perspective, the annualized rate of increase for 7.7 percent a month comes out as 143.6 percent! Unsurprisingly perhaps after such a dramatic development, the M3 rise in the year to June was almost 26 percent. This was the highest annual advance since 1943. (The M3 numbers quoted here are prepared by the Shadow Government Statistics consultancy, to whom the author is grateful. The Fed no longer estimates M3.)

The quantity theory of money and monetarism, its incarnation in the late twentieth century, are unfashionable nowadays. But the conjunction cannot be overlooked: exceptionally rapid money on the one hand has been followed, after a short lag, by buoyant asset and commodity prices on the other. One feature of the FOMC minutes during the crisis needs to be highlighted. Despite a rate of monetary expansion unmatched since the Second World War, the committee’s minutes did not once mention any money aggregate. The airbrushing of money quantities from central bank research in the United States arises from the New Keynesian ascendancy in policymaking, evidenced, for example, by Clarida’s prominence as Fed vice chair.

A major debate is imminent. The thesis of this article is that, at the intellectual level, the New Keynesian neglect of money is to blame for the looming resurgence of inflation. Let it be conceded that the resurgence could be averted by an immediate and precipitate drop in the quantity of money, if officialdom in the United States and elsewhere wanted to engineer such a drop. But instability in the rate of change in the quantity of money—so much deplored by Nobel laureate economist Milton Friedman in a long and influential career—would be a clumsy and destructive way to run any economy. Volatilities in money growth were recorded in the Great Depression of the 1930s and the Great Recession of 2007–2009, and are not to be recommended. Money growth will eventually need to be reduced to about 5 percent a year or less if low inflation is to be restored, but it will be best to return gradually to that sort of number. ◆

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