Unterrified Democrat
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Higher inflation likely to last

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The Consumer Price Index (CPI) increased at a 5 percent rate over the past year, the highest rate in more than a decade. Fed officials are quick to suggest that this increase is temporary; largely a result of the economy's post-pandemic re-opening. More likely, however, is that higher inflation rates will be with us for some time.

There are many examples of how the economy's re-opening is causing the measured rate of inflation to increase. Well-publicized shortages—in lumber, houses, computer processors, even the number of workers—have led to significant price increases in those markets. Some markets, such as gasoline, had substantial decreases in their prices a little over a year ago, so these rising prices are a return to pre-pandemic levels.

It is important to recognize that there is nothing policy makers can or should do about higher inflation that stems from shortages owing to the economy's re-opening. There are other reasons, though, why higher rates of inflation will persist into the future.

A persistent increase in the overall level of prices is directly related to increases in the supply of money. There is an old saying that inflation occurs when too much money is chasing too few goods. If the supply of money—cash, checking, savings, and similar accounts—increases faster than the public's willingness to hold it, they spend it and a faster increase in prices results.

Recent experience is consistent with this relationship between money growth and inflation. Between 2016 and 2019 the supply of money increased at an average rate of 5.4 percent. The rate of change in how the public is using it, called velocity, has been declining over the past two decades at an average annual rate of about 1 percent. These figures suggest an increase in spending on final goods and services, or GDP of about 4.4 percent per year.

This rate of growth in GDP is comprised of the rate of inflation and the growth in the production of those goods and services. To get to inflation, we need to subtract the latter. Since real GDP, the measure of total goods produced in the economy, increased at an average of 2.5 percent rate, subtracting this out leaves us with an estimated inflation rate of 1.9 percent. That's a pretty good prediction since the actual rate of inflation in the five year period averaged 1.6 percent.

So what does this mean for future inflation? The growth rate of the money supply soared during 2020 to about 19 percent. Why? Many people received extraordinary government checks in their checking accounts. While some used this money to pay for everyday expenses during the lockdown, some added these funds to their bank accounts. And for those who continued working, the pandemic-related shutdown led them to stash a greater share of their income into their accounts.

This increase in the money supply is now finding its way back into circulation. As the economy rebounds, people will draw down their bank accounts to spend. That means that velocity, after plummeting in 2020, is likely to return to its pre-pandemic trend. Put differently, people would rather spend their deposits than keep them at current levels. With an increased spending on a limited quantity goods and services, higher inflation this year and into the future will result.

What is different between this monetary-induced inflation and inflation caused by the aforementioned shortages in certain markets? Shortages eventually, and usually fairly quickly, disappear. Supply chain disruptions will resolve themselves, more goods will arrive to satisfy demand, and some prices will stabilize.

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even decline. Unfortunately, the Fed has committed itself to maintaining its easy money policy, known as quantitative easing, into the foreseeable future. This will pump more funds into the economy, feeding the monetary side of the money-inflation link.

The Fed is in a pickle. The only way policymakers can regain control over inflation, is to end its quantitative easing program. Because this would push market interest rates higher, don't expect them to act any time soon, however. Not only might higher rates slow the decline in the unemployment rate, but it also would increase the government's interest cost on its burgeoning debt.

If the Fed continues with its easy money, low nominal interest rate policy, prepare for inflation rates that are much higher than we've gotten accustomed to.

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