

Why Inflation Is on the Way Down

The Fed should ask Milton Friedman. When growth of the money supply slows, so does the increase in prices.

By Donald L. Luskin

The Federal Open Market Committee faces a momentous decision this week, with markets fully expecting a history-making second-in-a-row 0.75-point hike to the federal-funds rate. The hike at the prior meeting brought the key policy rate to 1.625%, where it was before the pandemic. But now, unlike then, the economy may be in recession, by some estimates having put in two consecutive quarters of contracting real output.

Normally the Fed would never raise rates in a recession. But the most recent consumer-price index data, showing 9.1% headline inflation year-over-year as of June, is anything but normal. The last time the committee faced such a difficult decision was in the early 1980s, under the chairmanship of Paul Volcker. His courageous determination to keep policy tight through two back-to-back recessions, the second of which was severe, slayed a persistent and embedded inflation and set the stage for decades of inflation-free growth.

Many Fed observers are calling for such courage today. Chairman Jerome Powell cites Volcker frequently, saying in May, “He had the courage to do what he thought was the right thing.” But it does an injustice to the legendary chairman to leave it at that.

“It wasn’t a particular thing,” Mr. Powell went on to say, as if courage was all it took. But it was a particular thing, and the FOMC would be wise to emulate it.

Volcker was a monetarist, very much under the influence of economist Milton Friedman, who won the Nobel Prize three years before Volcker became chairman. In his autobiography, Volcker wrote: “I came to appreciate Friedman’s basic contention that the supply of money . . . has a fundamental significance for the inflation process.” While chairman, he “tried to make clear the necessity for monetary constraint as the backbone for a forceful attack on inflation.”

Friedman taught Volcker that “inflation is always and everywhere a monetary phenomenon.” For Mr. Powell, inflation has gone from being a “transitory base-effects phenomenon” to a “supply-chain phenomenon” to a “Ukraine phenomenon” and now a “demand phenomenon.”

Yet the relationship between money-supply growth, as measured by M2 (currency in circulation plus liquid bank and money-market fund balances) and subsequent inflation has been statistically near-perfect in the pandemic era, with a 13-month lag. Year-over-year M2 growth began to accelerate during the pandemic recession in April 2020, and core inflation started to accelerate 13 months later, in May 2021. M2 growth peaked at a history-making, off-the-charts 27% in February 2021, and core CPI peaked 13 months later, in March 2022. Both M2 growth and core CPI have been falling every month since their respective peaks.

Experience is proving, 40 years after Friedman taught Volcker, that inflation is still a monetary phenomenon. But that tells us only what caused the present inflation, not what caused the money supply to grow so rapidly.

The answer puts Mr. Powell in a funny position as the official charged with arresting inflation, because the Fed didn't cause the underlying growth of money. We have to blame Congress for that. Since the onset of the pandemic, lawmakers have spent about \$6 trillion on various income-support programs for households and businesses, including three rounds of stimulus payments, extended and enhanced unemployment benefits, refundable child credits through the tax code, and forgivable Paycheck Protection Program loans. That all dropped straight into the bank accounts that are part of M2, which also grew about \$6 trillion over precisely the same period.

The Fed had nothing to do with that—except, perhaps of some significance at the margin, that Mr. Powell enthusiastically supported all three major stimulus bills.

The American Rescue Act of February 2021 was the largest and least necessary of the stimulus programs, but it was also the last. There's no plan for another, so that the normalization of money-supply growth back to pre-pandemic levels appears locked in, no matter what the Fed does.

As of the most recent data, for May, M2 growth stands at just 6.6%, lower than it was immediately before the pandemic. If the relationship with inflation continues, core inflation will be at only 2.3% in 13 months, in June 2023. If inflation is always and everywhere a monetary phenomenon, that's baked in the cake—even if it seems too good to be true.

Inflation Follows the Money



Source: Bureau of Labor Statistics, Federal Reserve

June gasoline and food prices are sharply lower so far in July. That points to a July CPI report, released in mid-August, that will show little inflation for the month, and possibly even a slight deflation. Then there will be one more CPI report for August, released in September, just before the FOMC meets again, and it will likely be benign as well.

Inflation expectations—in both markets and consumer surveys—are falling sharply. Break-even spreads in inflation-protected Treasuries have fallen to pre-pandemic levels that Mr. Powell and his predecessors Ben Bernanke and Janet Yellen all agreed were alarmingly low.

That's what happens when money-supply growth collapses. Always and everywhere. And that leads straight to a policy prescription that Friedman and Volcker would applaud: On Wednesday, the Fed should do nothing.

Under questioning by Sen. Elizabeth Warren last month, Mr. Powell admitted to the Senate Banking Committee that higher rates wouldn't cause gasoline or food prices to fall. Yet if the FOMC's 4.1% estimate for the unemployment rate under its present rate-hiking regime comes to pass, that's 800,000 livelihoods lost. Mr. Powell admits that hardship won't solve the inflation problem—and indeed with M2 growth back to normal, the problem is already solved.

Even if the Fed does what Volcker wouldn't have done and proceeds with the expected yet wholly unnecessary 0.75-point hike on Wednesday, that is likely to be the last hike. At the September FOMC meeting, after two benign CPI reports, all the committee will need to do is take credit for another slain inflation dragon and bask in Mr. Powell's courage.

We'll know where credit is due, however: to a Congress that finally sobered up on pandemic spending.

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