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ECONOTE No. 99 CPI inflation concerns in the US based on money growth are unfounded 28/2/2021

Summary

The recent crashes in the US, and in other government bond markets, were explained by fears of inflation, as economies are recovering from the CV19 and because of the explosion of money stock in the US. **The latter explanation is not backed by facts and expectations that rising money stock in the US will lead to rising goods and services prices are unfounded**. Asset price inflation has been rampant since the recovery from the 2008-9 crash—hence the near zero interest rates, But the prices of goods have stubbornly refused to rise fast or at all, irrespective of what has happened to money stock. Thus, to repeat, predicting that we are facing imminent CPI inflation because of the fast increase in US money stock is plainly wrong. “Monetarist” explanations of inflation are based on erroneous assumptions and are not backed by evidence.

Investment Conclusions

It is nearly a surreal contradiction that markets are concerned over the G3 central banks’ monetary policy and its impact on inflation given the utter failure of these banks to hit their decade long target of 2.0% inflation. But bond markets sold off on fears of inflation fueled by the explosion of M2 growth in the US. At the same time a cursory examination of the links between M2 growth, CPI and assets price growth will indicate that the central banks did engineer inflation—but that of asset prices but not of bread and shoes! Even the link between M2 growth in the US and asset prices is not that stable. So markets’ concern over inflation are either linked to factors other than M2 growth or they are based on “gut feeling” unconnected to facts. In either case M2 growth is not threatening a burst of CPI inflation.

A recap of plain, simple monetarism

The following is a very simplified version of the theory which postulates that rises in money stock cause prices to rise based on the so-called Quantity Theory of Money:

$MV=PT$

M is broad money stock, V is the velocity of circulation defined as the speed by which money changes hands, P is the price level and T is the total amount of goods and of services in the economy so that PT is broadly equal to the nominal GDP.A different way of defining V is simply PT/M, nominal GDP divided by money stock.

V is assumed to be very stable or to change very slowly, T is also slow to change as it depends on GDP growth. P can, and does, change very quickly, while M dynamics are a matter for central banks to press on or off the “print” button at any time they chose!!

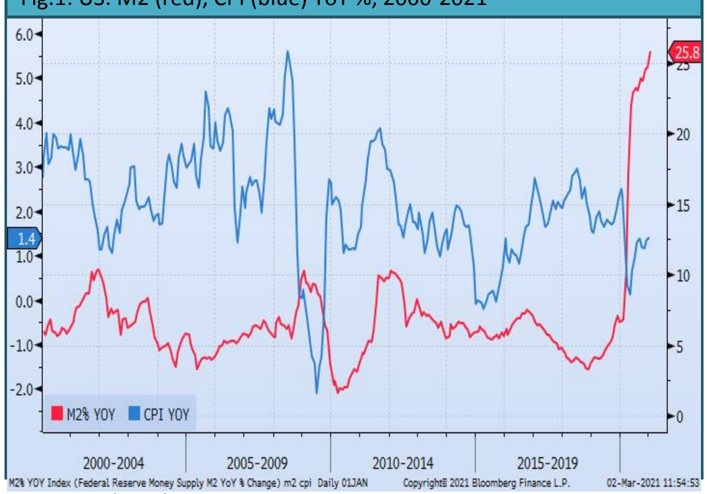
Now it follows that (+ denotes increase)

(M+) V =(P+) T, that is if Money stock increases Prices will increase as V and T will remain relatively unchanged or stable. Movements in money stock are reflected directly and quickly to movements in prices. The Figure in the Fact Box delivers a shattering blow to the key assumption of monetarism that V is stable or changes slowly. It does not! It has been declining over nearly 20 years and fell off a cliff recently. What is even more deliciously contrarian to monetarism is that as M2 growth exploded in 2020-21, V collapsed not causing prices to go up, but potentially keeping them unchanged. Fig 1 also shows that for periods such as 2002-2005,and 2014-19, M2 growth and CPI moved in opposite directions even allowing for some lags in their putative relationship.

Why velocity has been falling

We may think V as the percept of nominal GDP being held in money balances, and that percent has been rising almost continuously. Why “people” hold more money as part of their nominal income may reflect cautiousness, uncertainty, (the latter, not too surprising, during CV19 let alone in the aftermath of 2008-9) and the fact that with zero-rates since 2008-9 there is no interest income lost in holding money.

Fig.1: US: M2 (red), CPI (blue) YoY %, 2000-2021



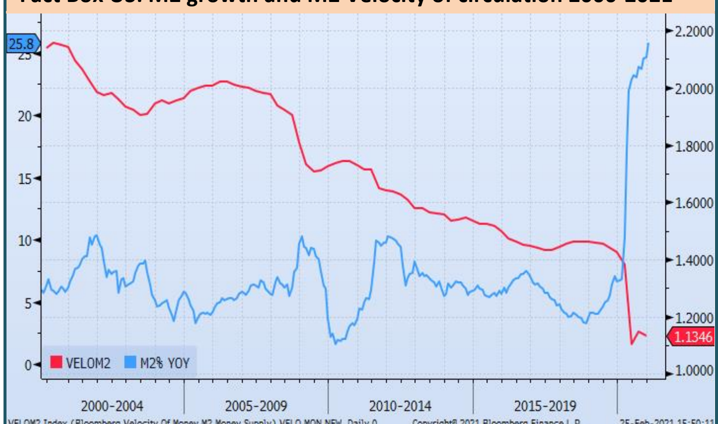
Source: Bloomberg

Finessing the argument on monetarism

Who are these "people" who hold more money in their balances? The money supply in the US rose sharply since Feb. 2020 mostly because the Fed bought nearly USD 3.0tr of bonds directly from corporates, financial institutions and indirectly from the government. Buying from banks raised their liquidity making it easier for them to lend. Banks also bought bonds and related assets thus adding to the money supply. Holders of bonds ended up with fewer bonds and more bank balances. But holders of bonds are mostly financial institutions, pension funds, investment houses etc, but not the average Mr. and Mrs. US citizen. These institutions did not rush to use there newly found cash balances to buy bread and shoes but bought instead other financial assets and especially stocks. The increased demand for bonds by the Fed raised their prices and lowered yields, so much so that in economies such as Japan and Germany, where BoJ and ECB were also buying bonds as if there was no tomorrow, yields became negative rather than just zero!

Confusing you with facts... The Fed by increasing its balance sheet by buying bonds, created deposits with the Fed and consequentially deposits with the banks as the sellers of the bonds received their

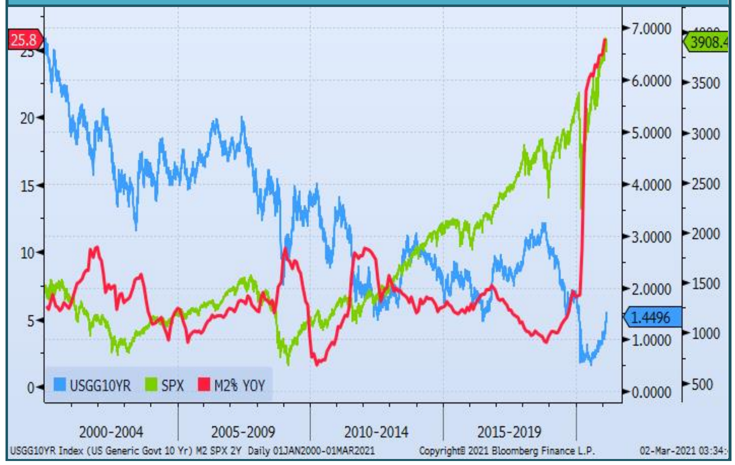
Fact Box US: M2 growth and M2 Velocity of circulation 2000-2021



Source: Bloomberg

payments in bank deposits. The overall increase of deposits in the economy led to portfolio reshuffling as this cash was used to buy other financial assets such as stocks. Prices of financial assets increased as is shown in Fig.2 with prices of bonds rising almost continuously since 2008 (yields falling) and the same for stocks. So although there is no clear continuous link between M2 growth and asset prices, **the Fed did cause inflation by its actions, but inflation in the prices of assets but not of bread and shoes!** (See again Fig. 1). The Fed did not necessarily need to increase money stock by a single sharp go, but nonetheless caused assets prices, and especially those of bonds, to rise by keeping Fed funds at near zero levels and buying bonds continuously in the market as part of the Quantitative Ease initiative. The pathetic attempts over the last decade of the Fed, ECB and BoJ to hit tiny inflation targets of 2.0% have consistently failed because the tool used, increases in money stock, did not percolate to the purchase of milk, T-shirts and tinned tuna but only to financial assets--these policies not being helped by the continuous fall in Velocity.

Fig.2: US: M2 growth, S&P 500 and 2Y bond prices, 2000-2021



Source: Bloomberg

Drawing the all string toegther

Concerns that inflation in G3 will accelerate as the global economy begins its recovery from CV19, were augmented by the explosion of M2 in the US and the continuing concerns over the zero iterest rate policy of extreme monetary ease.Belief that all inflationary experiences are always and everywhere caused by monetary expamsion is difficut to eradicate despite the fact that it has had little factual backing but could be partially useful in understanding only some extreme situations such as wartime inflations.As we show here, one of the key tennents of the monetary explanation of inflation is the relative stabiity of velocity of circualtion, which in fact has not been stable but has been declining in the last 20 years and accelerated its fall during the last 12 months with the growth of M2 in the US.There are, however, two complications which need to be addressed.**First** inflation is measured by the CPI which contains weighted prices of key components of consumer spending but not asset prices.**Second** prices of financial assets, such as bonds and stocks, have been rising alsmost continuosly since 2009 a rise undoudtedly helped by the extremely loose monetray policy which was not achieved by historically high increases in M2 but by pushing both short and long term interst rates and yields to nearly zero.It is therefore worth repeating that the Fed (and for that matter the ECB and BoJ) did succeed in pushing inflation up but not of the prices of bread and shoes but of financial assets.In that sense the financial markets should have been more concerned by asset price inflation falling as recovery took place and the need for zero interest rates disappeared, rather than CPI accelerating something which is unconnected to M2 growth.

Andrew Freris (writing completed on 28/2/2021)