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Eco note No. 108 Current inflation and why higher interest rates will be ineffective in controlling it. 30/7/2022

Summary	Conclusions
Inflation is not always and everywhere a monetary phenomenon; it can explain assets inflation but cannot explain the rising prices of bread, milk and shoes, which require a simple but different explanation. The Fed, ECB (but not the BoJ or PBOC!) are fighting goods inflation as if it is assets inflation and, hence, their policies has brought down precipitously assets prices but not the prices of gas, oil, wheat, coal etc. The assets markets are now responding in a deranged manner having discovered Newtonian Financial Physics for Idiots (Doh!). The last hike of the Fed was greeted with rising share prices and falling longer term yields on the basis that things, which go up, will eventually come down! Yes, quite. Next Economics Nobel prize winner, please! Hiking rates will do collateral damage to sectors not contributing to inflation but may dent inflation in the process, while leaving unaffected its major causes. Go figure!	The current surge in inflation contains 3 parts**.** **(1)** The impact of the Ukraine war on the prices of energy and commodities which has nothing to do with the monetary expansion since 2008 and especially since 2018.In any case, the velocity of circulation of M2 in the prime culprit, the US, fell off a cliff since 2018 but flattened out since 2020.People accommodated more money in their balances and did not spend it thus adding to demand pressure, as the monetary approach to inflation suggests. **(2)** The outbreak of Covid in 2019 impacted supply chains, which caused shortages, which have not gone away. **(3)** Since 2021 there has been some recovery in some economies, and this may have added to demand pressures. **But hikes in rates will have no effect on (1) and (2) and only selectively on (3).**

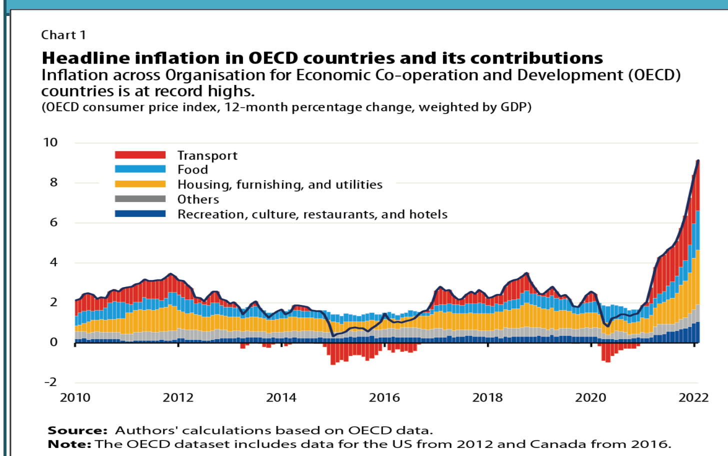
Ockham's razor to rescue! Slicing through the dross!

Medieval monks would have had a feast in 2022.Faced with an avalanche of data, and worse, interpretation of the data, William of Ockham (1287-1347) a Franciscan monk, would posit the principle that simpler explanations of inflation should be preferred to more complex ones. These explanations would also be more likely to approximate the truth. In other words cut out the complexities and details and, hence, the reason for the razor.

So here goes our approach to the current state of inflation. Fig.1 is an excellent summary of the drivers of inflation in major economies. Transport dominates reflecting the increases in the prices of oil which affected road transport as well sea freight rates. This also reflected the snarl-up of the availability of containers also leading to steep freight rises. Food reflects the shortages, among others, of wheat and corn, the last two because of the disruption of exports from Ukraine and Russia. Add to that the impact from Housing and Utilities, the latter creating a major inflationary push in the EU and UK primarily because of the dependence on Russian gas imports. All these drivers cannot, and will not, be controlled or reversed by higher interest rates in the US or EU or anywhere else for that matter.

So why hike rates? The answer is blunt. Higher interest rates will affect a number of activities in the economy, such as property and housing via mortgages, such as industrial investment via tighter and more expensive credit, and consumer spending via higher costs of bank loans and of credit card charges. All these will impact the prices of most goods but will not impact the prices of oil, gas, and of commodities, let alone reverse them. However, this will also affect the demand for labour and may limit the rise of wages, thus further impacting consumer demand and labour costs in the manufacturig and service industries.But all this makes it clear that hiking rates will do first a great deal of damage to sectors of the economy which are unrelated to the surge in this inflation.This is a scatter gun policy mostly missing the real causes of inflationary pressures.But meanwhile the higher interest rates has devasted asset prices but this is not the aim of the Fed and of ECB, who are interested in the prices of bread, milk and of shoes.

Fig 1. Inflation drivers in OECD, 2010-2022

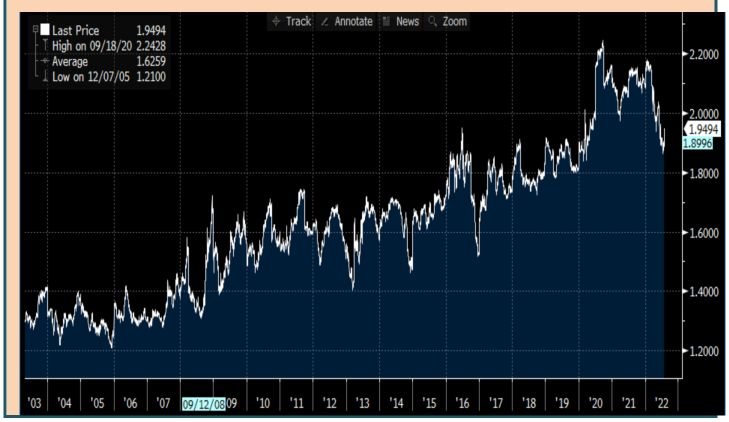


Source: IMF, June 2022

Inflation, money and asset prices

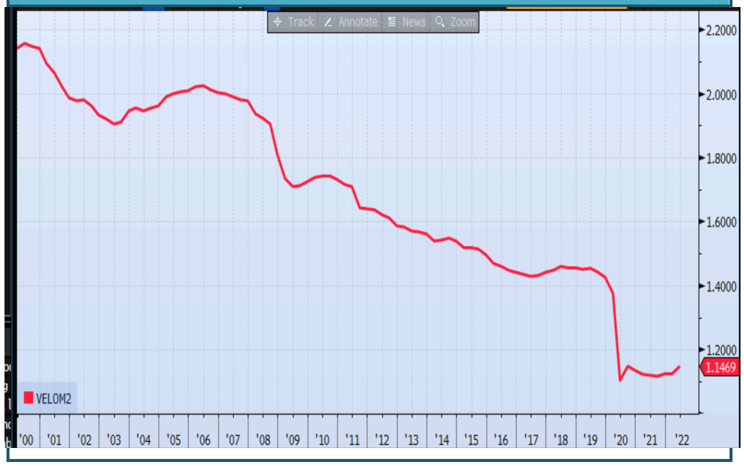
The Quantity Theory of Money, (QTM), that zombie from the 1960s and 1970s, has been dragged from its grave in order to blame the current inflation on the very loose global, and US in particular, monetary policies since 2008.The QTM is based on the simple assumption that the demand for money as a percent of people's assets, or for that matter of GDP, is stable. Hence increases in the supply of money will lead people to balance their portfolios by spending the "excess" amounts and thus leading to increases in the demand for goods and services. A sharp rise in demand is not balanced easily, or at all, in the short to medium run, and thus leads to rises in prices. This simple approach can be summarised by the well- known equation MV=PT, where P is the price level, V is the velocity of circulation of money defined as the ratio of Nominal GDP/Money Stock and T is the real amount of goods and services produced in the economy. As T is unlikely to change quickly as demand varies, and if V is stable or changes very slowly, then an increase in M will be reflected in an increase in P, and Hey Presto, inflation is a monetary phenomenon. Figs 2 and 3 show evidence that, in the cases of the US and Japan, velocity was stable nearly since 2000, had been mostly declining. Hence as M increased it had little or no impact on P as V fell. People accommodated the increases in money stock in their balances and did not spendit.Fig.1 shows GDP/M2 for the US (falling) while Fig2. Shows Japan's M2/GDP rising, (the equivalent to GDP/M increasing). In both cases velocity started being stable or even rising from 2020-21 onwards. In all fairness to the QTM, the formula and its explanation are too simple to be "mechanically" correct, but the evidence over a 20-year period is convincing. Incidentally, Japan's nominal GDP fell in absolute terms from 2019 onwards as did US's from 2019-20,but rising again in 2021.With rising M2 stock, the GDP/M2 ratio should be falling but here it remained stable in US, but actually rose in Japan.In other words people kept their money balances at constant or even increasing ratio to their incomes, unlike the case since 2000 when they kept decreasing the ratio. The behavior since 2019 may reflect the reaction to Covid and its immediate and destructive impact on people's livelihood, coupled with the extra liquidity pumped by the US, ECB and BoJ which was immediately spent in an environment of **falling nominal incomes.** But note, however, that this in no way negates the argument that the extra money spent did not cause the shortages of gas, oil, soft commodities and of manufactured products impacted by supply chain constraints.

Fig.3: Japan, inverse velocity of circulation, M2/GDP, 2003-2022



Source: Bloomberg

Fig.2: US, Velocity of circulation GDP/M2 2000-2022



Source: Bloomberg

So what happens next? No prizes for guessing

Lost in the translation is the fact that doubling the price of gas or of oil or of salami slicing machines etc will have **a one off** impact on inflation. The only way gas prices etc can carry on adding percentage points to inflation is if they keep increasing every quarter or every year, which they will not. The one-off impact may, of course, lead to chain reactions of expectations of further increases, which may not materialize. It is here where, reluctantly, we can agree that hiking rates may act as a deterrent to further prices increases at home. But consider the absurd syllogism on which this premise based. **" Mr. Manufacturer of salami-slicing machines, which use steel, plastic, paints and microchips, as well as labor which is pressing for higher wages, all of which are now costing you more. You now appear to be increasing the prices of your products in order to cover the increases in costs. Not only that, you expect that all these costs will carry on rising in the future. Now you will be hit by higher interest rates, which will add, to your costs (incidentally this is the "Erdogan corollary lemma" that higher interest rates cause inflation !) and by tighter credit, which will limit your investment and you capacity to carry inventories. Hence, you will think twice about hiking your prices, which reflect your costs, and over which higher interest have absolutely no effect. Hopefully, as the sale of salami slicing machines falls because of higher costs and, hence, prices, as well as fewer workers are employed, all this will add to pressures on steel, plastic, paints and labor prices and will begin to slow down inflation."** It is difficult to know where to start to disentangle this syllogism, including feeling a little sympathy for Mr. Erdogan, although here we left forex rates out as the Fed, the ECB and, most definitely the BoJ, do not seem to be concerned over them.

There is clearly one consequence of higher rates as a cure of predominantly supply side inflation; it will work in lowering inflation but at a high cost on the domestic sectors of the economy, which are innocent of any inflationary pressures. An unknown Mexican saying has it as "Hit the piñata long and hard enough and the ATM will finally disgorge some pesos". Ask he Fed if it has heard of it.

Our conclusions: Higher rates will not work to control this inflation and the costs of trying to do, GDP recession, will lead to their reversal within the next six months. Inflation, by then, may abate if the Ukraine war is coming to some form of an end, but also helped by the GDP impending or actual recession.