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Inflation

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During most of 2021, many economists, the Fed, and the Administration downplayed building inflation, attributing it to temporary factors caused by the Covid pandemic. Jammed supply chains, labor shortages, and rising commodity prices were all expected to recede once the pandemic-related distortions abated. The narrative shifted when the data overwhelmed the naysayers and the distortions remained unresolved. A front-page article in The New York Times on December 26, 2021 was titled "As Prices Rise, Biden Deploys Antitrust Team." The article goes on to describe government agencies pursuing many industries, including meat packers, transportation companies, energy producers and others with accusations of price gouging and other nefarious anti-competitive behavior. The article does concede, "Corporate culpability for rising prices remains unclear." And, "White House officials concede that their antitrust moves are unlikely to reduce costs for U.S. businesses or consumers immediately."

Amazingly, governments believe the way to solve distortions, generally initiated by their policies, is to impose more distortions. In the U.S., the government cites profitability in some industries to argue a deficit of competition allows greedy executives to raise prices. Showing an alarming lack of understanding and self-reflection (and perhaps merely for political posturing), the government fails to analyze or investigate the reasons companies are forced to raise prices. Starting with the obvious, the pandemic caused shortages due to lockdowns, employee absenteeism, illness, and departures. Demand for many products, including beef and autos, grew because consumers saved more while unable to dine out or travel. We all know fewer products and higher demand generally translate into higher prices.

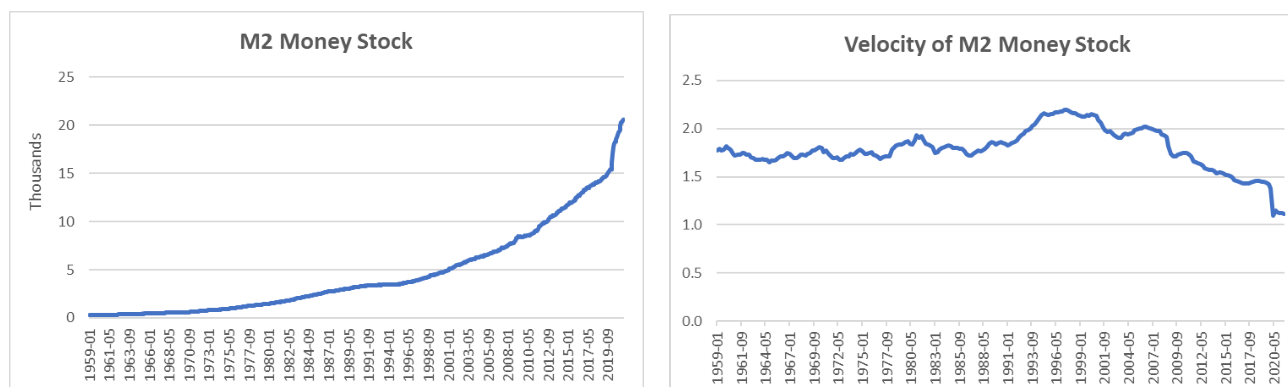
Add to this, the highly distortionary government policies enacted to combat the pandemic. Almost all countries followed the same script – business closures, isolation efforts, lengthy quarantines, and recently, mandatory vaccinations and testing. The whole world has been affected in some way by what is agreed to be "covid-related protocol." The new normal has repercussions that alter work routines and livelihoods globally. In China and other Asian nations, the pursuit of "zero covid" shut down cities, manufacturing plants, ports, and other critical venues in the global trade network. In the U.S. businesses cannot find enough employees forcing them to pay higher wages and restructure processes. Just two months ago, a record 4.5 million people quit their jobs likely lured by nearly 11.0 million job openings and generous compensation incentives. To further illustrate the magnitude of the labor shortage, the Labor Department reported there were 6.3 million unemployed Americans in December, confirming that between openings and quits there are not enough workers to satisfy demand.

Nearly two years into the pandemic, effective steps to manage infections and return to "normal" remain elusive. It seems likely some form of Covid-19 will remain endemic and, unless society accepts certain levels of illness in their lives, the Covid protocol will continue to determine how people work and live. This means businesses must adapt to personnel deficiencies, office disruptions, and product shortages. People's consumption habits will likely change, and service industries may experience slackening demand. While we are probably well removed from the days of hoarding toilet paper and cleaning supplies, we are likely to experience other distortions thanks to the government's efforts to alleviate the problems. Recently, both China and Europe faced energy shortages that drove massive increases in prices for natural gas, coal, and electricity. Well-intended green energy transition policies backfired when renewable generation faltered and fossil fuel supply could not cover. Distorted conditions like we have faced for the last two years, do not mean companies conspire to rip off consumers. On the contrary, companies go to extreme efforts to help customers by trying to get them the products they need under challenging conditions.

Milton Friedman, a well-respected economist, and frequent government policy critic said, "Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than output." The government confronted immensely difficult decisions as the pandemic unfolded. Thankfully, the Fed stepped in to avoid a financial crisis during the first and second quarters of 2020. However, as often

happens, emergency measures tend to be extended because when crisis conditions do not reverse quickly, policy makers come to believe the economy cannot function independently. Eventually, as we are currently witnessing, markets become dependent on government aid, and react negatively to indications they may have to fend for themselves. In the end, policy makers put themselves in a quandary having to choose between an undesirable moral hazard and applying the brakes on a fragile economy.

As we head into 2022 with raging inflation (by recent standards), unemployment below 4%, ample consumer savings, robust corporate balance sheets, and record global covid infections, the Fed faces a dilemma. Over the last two years, the central bank's stimulus programs contributed to a massive 38% expansion of the money supply (M2). Now, the delay in recognizing mounting inflationary pressures means it has to turn on a dime, from adding funds, via asset purchases, to withdrawing them and raising short-term rates. Part of the Fed's delay may have been due to economists' attachment to a widely held "rule" in economics called the "velocity of money." Strictly, velocity refers to the number of times an additional dollar is used in the economy. Numerically, velocity is measured by dividing GDP by the money supply. The rule holds that for incremental money to be inflationary, velocity has to increase. This has not happened. In fact, velocity has declined. The graphs below show the aggressive expansion of M2 along with declining velocity.



Source: Bloomberg, Federal Reserve Bank of St. Louis, January 1959 to July 2021

The Fed's mandates are maximum employment and stable prices. Generally, their policy actions seek to aid a faltering economy or cool an overheating one. The pandemic hardly qualifies as a "standard" economic occurrence. So, although the Fed's intervention was essential in 2020, it seems logical, even likely, that standard economic tenets may not apply to an economy forced to shut down. Equally, the validity of standard measurements might be questioned when the Federal government infuses 20% of GDP in fiscal stimulus and it is all funded by the central bank. Clearly, GDP declined in 2020 for reasons that had nothing to do with the economy's underlying strength at the time, and the money supply exploded to address a once-in-a-lifetime crisis. While Friedman's observation was on target, even he might suggest money velocity is not a good yardstick, under the circumstances.

The world is unlikely to repeat the great inflationary periods of the past. However, the government's incursion into the economy, which began to address an emergency, seems to have morphed into a permanent take-over of vast portions of the private sector's domain. With the government's abysmal record of economic management, a worrisome scenario is that a long period of stagflation may be on the horizon.

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