Inflation post #3: The Consensus. Date 2022-05-28

Since October 2021 I've warned that we had broken from the disinflation regime of the last 30 years. The trigger, as I wrote in the second edition of my book, published September 2021, was the massively exaggerated monetary policy response to the Covid-19 pandemic. As the mainstream Economists gradually acknowledge that inflation is proving to be consistent, I want to explain further why I feel they are still underestimating the problem, and the monetary factors that underpin the current and future inflation prospects.

In 2020 and 2021, the money supply in the US increased by about 45%, with most of the rise happening from April to September of 2020. Even with a record surge in the money supply, inflation showed no signs of being a "problem" up to September 2021. Even until early 2022, inflation was dismissed as a transient phenomenon, with price surges attributed to pandemic-related supply chain disruptions.

My research on inflation is based on common sense relationships, such as the equation of exchange, used in monetary economics, which states that Nominal GDP = M x V, where M is the money supply and V is the velocity of money. As countries worldwide locked down to contain the spread of the SARS-CoV-2 virus, economies took a historical hit which led to the central banks increasing the money supply by record amounts. As record amounts of money were created by central banks, the velocity of money decreased even further, making inflation appear to be subdued.

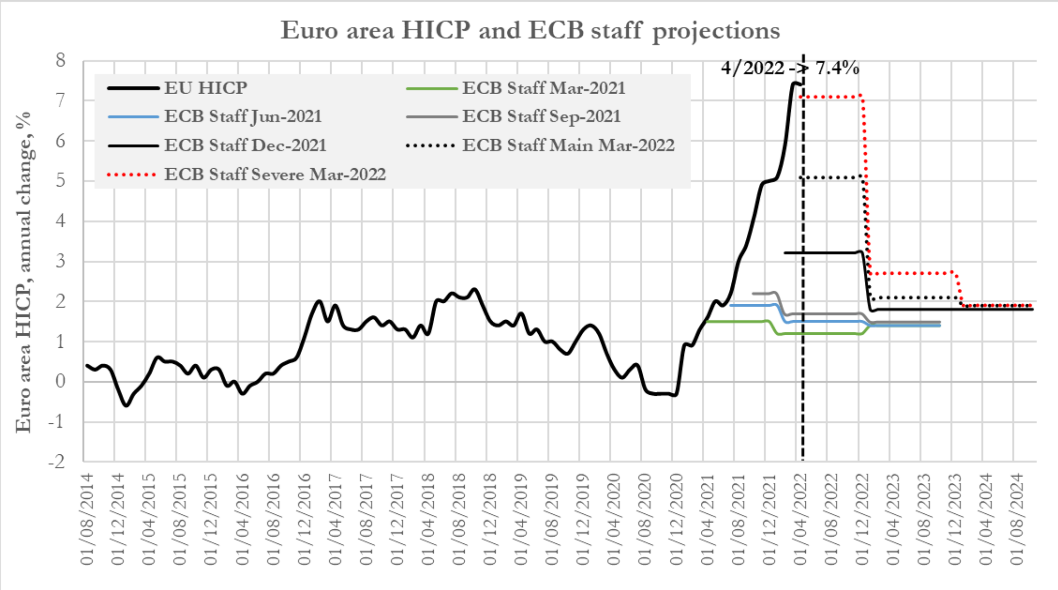
By using a very simple analysis (back of an envelope calculation), we can quickly conclude that once the economy normalises and the pandemic measures subside, the 45% increase in money supply should be fully reflected in nominal GDP at some point. If this normalisation process occurs in the next five years, then I estimate that we are looking at the prospect of an AVERAGE rate of inflation of about 6.8%. Inflation is therefore not temporary; it is here to stay, and its source was a product of a monetary policy implemented in April 2020.

The Economists' consensus

Central bank staff are some of the smartest economists from the most prestigious universities. How did they miss this fundamental point? In case you think I'm exaggerating their blindspots, I've put together the historical ECB staff macroeconomic projections for the Harmonised Index on Consumer Prices (HICP) for the Euro Area[1]. The plot below illustrates the ECB staff projections versus actual outcomes for the HICP index.

The graph shows that the ECB staff projections for inflation have consistently undershot the actual outcome for inflation. All projections point to a stabilisation of inflation in a year or two, towards the ECB target of 2%. I wonder if the ECB staff suffers from groupthink so that their projections are guided by their belief in the effectiveness of policy management by the ECB. If so, then HICP should not be at current levels; but indeed, they are.

1 https://www.ecb.europa.eu/pub/projections/html/ecb.projections202203_ecbstaff~44f998dfd7.en.html



Even the extreme scenario for the ECB staff assumes that inflation will average 7% in 2022 and then drop to 2.7% in 2023. My view is that the extreme ECB staff scenario is actually the most likely scenario but that it underestimates longer-term inflation pressures.

The Market consensus

What does the market say? As I've illustrated in my previous post, the market consensus a little bit more sceptical that central banks can keep inflation in their target ranges. In the US, the 5y breakeven rate for US treasuries stands at 3.3% which means that inflation could stay higher for longer than even the extreme outcome from the ECB staff projections.

Date	01/5/2022
5y Breakeven rate	3.3
10y Breakeven rate	2.88
5y-5y forward rate	2.46

Before 2008, even in periods of subdued inflation of 3% or so, bond vigilantes would be on the mainstream media news networks voicing their concerns, putting severe pressure on policy makers and markets. These days the bond vigilantes are either eerily quite or scarily cavalier regarding inflation concerns. When will the bond vigilantes rebel or are they irrelevant in a world dominated by central bank liquidity?

As mentioned before, I believe that both the market and policy makers are wrong and that we'll experience an average inflation of about 6.8% in the coming 5 years. Inflation will not be stable during these years but instead will be like a roller coaster with periods of deflation, stagflation and large inflation that will confuse policy makers and the markets.

In my following posts I will address in further detail certain aspects of the current surge in inflation so that you can understand better its context and consequently the potential future outcomes. Namely, I will address the current mainstream theoretical underpinning of the Phillips curve (relationship between unemployment and inflation), the demographics deflationary backdrop of the past 30 years, and the dangers for inflation which lie ahead.