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WITHOUT FED TAKING ACTION, INFLATION WILL BE HERE TO STAY

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That whirring noise you hear is Milton Friedman spinning in his grave.

The revered libertarian economist famously said, “Inflation is always and everywhere a monetary phenomenon…”

That’s exactly what’s happening now in the economy. You can talk about supply driven inflation, or demand driven inflation, but the short story is that the money supply is out of control, and it’s causing inflation.

OK, so how does the money supply affect inflation? Assume that the entire stock of goods in the economy consists of 100 apples, and the entire money supply is $100. Obviously, apples are S1 each. If the supply of apples grows to 125, and the money supply grows to 125, apples will still cost $1. However, if the money supply grows to $125, and the supply of apples stays at 100, apples now cost $1.25.

If you have $1, your ability to buy apples has gone down, and you can now only buy 80% of an apple. You’ve been taxed out of 20% of your purchasing power just the same as if you wrote a check to the government.

Who got the extra purchasing power you lost? There’s a relatively complex answer to this, but the short answer is whomever gets blessed with the additional money created by the Fed.

The measure of the money supply, most commonly used is “M2,” the total of cash, checking deposits, savings deposits, and money market securities.

If the money supply is constant, a price increase in one good or service is accompanied by price decreases in others. Inflation occurs when prices of goods and services increase overall.

The root cause of inflation is the money supply’s increasing faster than the growth of goods and services. More money in circulation chasing the same amount of goods and services equals inflation.

This inflation may be accelerated, or exacerbated, by temporary disequilibrium in supply or demand, but the underlying cause of price increases is excessive growth of the money supply.

And that’s exactly what we have now. Recent year-over-year growth of M2 is approximately 12%-13%, down from much higher levels earlier in the year. Obviously, the growth of goods and services is nowhere near that level.

The result is inflation, and it’s inflation that’s here to stay, if the money supply continues to grow at anywhere near this rate.

As a result, inflation is not transitory; it’s continuing. How long it continues depends on the Fed’s management of the money supply going forward. The longer inflation exists, the harder it is to wring out of the economy. Many of us remember the ‘70s when home mortgage rates neared 20%, and Paul Volcker tightened down on the money supply, eventually reducing inflation and interest rates. It was painful, but necessary.

The bottom line is that inflation has reared its ugly head, and it’s going to be a part of our economic landscape long as the Fed lets it.

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