Is Inflation Really Transitory?

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Financial-market indicators point to a persistent uptick in inflation.

DESPITE a few recent hints of unease, the Fed still maintains that the current surge in inflation is "transitory." That seems optimistic: The central bank has been stoking inflation and is stubbornly blind to the danger of getting more than it bargained for, of letting loose what Nobel Prize–winning economist Friedrich Hayek described as the "tiger."

Fed chairman Paul Volcker caged inflation after it'd crested at 13.5 percent in 1980. Since then, however, the Fed, politicians, consumers, and producers have become complacent about the risk that it might escape again.

The current cocktail of money-printing, massive deficit spending, pandemic-related supply-chain disruptions, and pent-up demand coming out of COVID-19 hibernation means inflation ahead — and not just for the short term. The outlook is only made worse by the hit to the supply side that will come from increased regulation and taxes, not to speak of the boost to energy costs that will flow from the administration's hostility to fossil fuels.

The Fed's balance sheet has ballooned from $900 billion in August 2008 to a whopping $8.2 trillion in mid July 2021. However, by paying banks interest to park excess reserves held at the Fed, the central bank has managed to keep new dollars from entering the economy in the form of credit, thereby holding down inflation. Now, printed money is showing up in consumption and price data, and the longer the "transitory" surge endures, the more difficult it will be to contain.

The July and June CPIs were up 5.4 percent year-on-year, the highest increases since August 2008. In July, gas and used-car and truck prices were up 41.8 percent and 41.7 percent year-on-year, respectively. On August 12, 2021, natural-gas futures were up 68 percent year-on-year per million British thermal units.

Asset bubbles are building.

The Schiller price-to-earnings multiple of some 37x is at the highest level in a century except for the dot-com bubble. In June the median existing-home price was up 23 percent year-on-year.

In May, Fed governors Lael Brainard and Christopher Waller downplayed inflation as "a transitory surge" and "temporary," respectively. Treasury Secretary Janet Yellen, former Fed chairwoman, suffers the same groupthink. She declared, "I don't think there's going to be an inflationary problem. But if there is, the Fed will be counted on to address them." In June, she allowed that inflation might remain at 3 percent through 2021 but would be "transitory." In an August 5 talk on digital currencies, Fed governor Waller characterized inflation as "somewhat transitory."

In his July 14 semiannual monetary policy report to the House Financial Services Committee, Fed chairman Jerome Powell insisted that elevated inflation was temporary. Pressed, Powell said recent price hikes will fade and that any tapering of the Fed's $120 billion in monthly bond purchases was "still a ways off." In his July 28 press conference, Powell attributed pricing pressure, i.e. inflation, to supply bottlenecks and insisted as "transitory supply effects abate," that inflation would drop to 2 percent.

In the Yellen and Powell reigns there hasn't been a single dissenting vote on monetary policy. In uncharted monetary waters in July, members of the Federal Open Market Committee, which takes monetary-policy-implementation decisions, yet again took refuge in voting unanimously.

The Fed's July 28 statement displays a kind of monetary cognitive dissonance. It seeks to reassure markets, the Biden administration, and Congress that it's on the inflation ball, while promising to maintain the gusher of easy money for the foreseeable future. The central bank plans to keep its target benchmark interest rate range of 0 to 25 basis points, to continue buying $80 billion of Treasuries and $40 billion of mortgage-backed securities monthly, and to maintain the interest rate it pays on excess reserves that banks hold at the Fed at a paltry 15 basis points. It said it is currently aiming "to achieve inflation moderately above 2 percent for some time" to catch up for the previous period in which inflation had been below the then-hallowed 2 percent target, and that the Fed "expects to maintain an accommodative" monetary stance.

Interest rates are the economy's most important price, the price of future versus present investment and consumption. Real benchmark interest rates are negative. You don't have to be an economist to understand that that's nuts.

The Fed has the tools and a statutory mandate to pursue "stable" prices. But since 2012 on its own prerogative, it has targeted 2 percent inflation. In 2020, as alluded to above, the Fed, again on its own prerogative, upped the ante, adopting an inflation-averaging policy, meaning it would permit and indeed encourage higher inflation to catch up for past inflation deemed too low.

Inflation doesn't have to be Venezuelan or Zimbabwean hyperinflation to be destructive. It's a tax diminishing the value of dollars earned and saved, and it increases the effective income- and capital-gains tax rates. It can cause systemic malinvestment, and it transfers wealth from creditors to debtors — the biggest of which is Uncle Sam. While the observation may not be fashionable in Washington, gentle deflation would benefit many consumers and businesses. Joe and Sally Sixpack would welcome a kilowatt-hour, crown, college tuition, and gas that cost a bit less next year, assuming — an important caveat — that this was not accompanied by falls in nominal income.

The Fed's signal that it may raise its benchmark rate modestly by the end of 2023 is really a promise of continued easy money. The commitment to stay the course buying Treasuries and mortgage-backed securities and Chairman Powell's comment that inflation will run "above our objective for a few months" before falling underscored the fact that the central bank remains in denial about inflation.

For the Fed to believe that it can and should use creative monetary policy to manage the macro-economy is a remarkable display of hubris. While the Fed has cultivated and enjoys a stellar reputation on both sides of the political aisle and with much of the public, its track record since its 1913 creation has been less than stellar. The dollar has lost 96 percent of its value, and the U.S. has suffered multiple financial and economic crises.

On June 22, Chairman Powell assured the House Select Subcommittee on the Coronavirus that double-digit inflation was "very, very unlikely." Not however, if the Fed doesn't act decisively. Time for Volcker 2.0.

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