Who Gets the Blame for Inflation

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Consumer prices rose 7.0% in 2021, the largest increase for any calendar year since 1981. As a result, politicians across the political spectrum are working overtime to find someone to blame and attack.

Some politicians on the left are blaming "greedy" businesses for inflation. But we find this explanation completely ridiculous. Of course, businesses are greedy, in the sense that they're run by people who are free to maximize their earnings!

But businesses are no greedier today than they were before COVID. In the ten years before COVID, the consumer price index increased at a 1.8% annual rate; in the twenty years before COVID, the CPI rose at a 2.1% annual rate. Both figures are a far cry from 7.0%.

Those blaming greedy businesses for higher inflation have no rational explanation for why businesses somehow missed all the opportunities to raise prices faster in previous decades but suddenly had a "eureka moment" and decided to do so in 2021. Under this economically illiterate theory, think of all the profits they've voluntary foregone for decades.

Meanwhile, think about the rapid increase in workers' pay in 2021, when average hourly earnings rose 4.7%. Did workers suddenly become greedier, too? Is all this greed contagious? Can we stop it by wearing masks? What does the CDC have to say?

But the political left is not alone in misunderstanding higher inflation. Some politicians on the right are saying the inflation is due to the huge surge in COVID-related government spending and budget deficits. Part of this is likely tactical: by blaming government spending and deficits, they can reduce the odds of passing the Biden Administration's Build Back Better proposal, which they'd like to see defeated.

What they're missing is that there is no consistent historical relationship between higher spending, larger deficits, and more inflation. Yes, inflation grew in the late 1960s after the introduction of the Great Society programs. But government spending also soared in the 1930s under Roosevelt's New Deal, without a surge in inflation. Budget deficits soared in the early 1980s and inflation fell. The Panic of 2008 led to a surge in government spending and deficits and inflation remained tame.

So, if it's not greed or government spending, by itself, then what is causing higher inflation? We think it's loose monetary policy. The M2 measure of the money supply has soared since COVID started. That is the (not-so-secret) policy ingredient that has converted extra government spending and deficits into more inflation rather than higher interest rates.

That, in turn, makes it important to follow the path of monetary policy this year and beyond. In recent weeks, a number of Fed policymakers have hinted at rate hikes starting in March, including Mary Daly, the president of the San Francisco Fed and considered a dove. Rule of thumb: when the doves get hawkish and start hinting at rate hikes, it's time to believe the hints.

The futures market in federal funds is pricing in four rate hikes this year. For now, we think the most likely policy path is three hikes – 25 basis points each: in March, June, and December, with a hiatus for the mid-term election season.

In addition, we think the Fed finishes up Quantitative Easing (QE) in March and starts Quantitative Tightening (QT) around mid-year. The easiest and most straightforward way for the Fed to do QT would be by selling Treasury and mortgage-backed securities to the banks and having the banks buying them send their reserves back to the Fed. The Fed can then erase those reserves from its balance sheet. That would result in the Fed holding fewer bonds as assets while being liable for fewer reserves, reducing its overall balance sheet. Instead, the Fed will probably take a more complicated path of not rolling over some assets when they mature, which means the Fed will have to coordinate its operations with the Treasury Department.

The key to remember, though, is that a few rate hikes and some modest QT will still leave monetary policy too loose. "Real" (inflation-adjusted) short-term rates will still be negative while actual short rates remain well below the trend in nominal GDP growth (real GDP growth plus inflation).

The Fed has its work cut out for it. Its goal is to execute a reduction in inflation while sticking a soft-landing for the economy. A year from now, we'll have a much better idea whether it can meet both these goals.