Desmond Lachman - What Happens Next
Sunday, March 13th, 2022

Larry Bernstein:

Desmond, why do we see 7.9% inflation?

Desmond Lachman:

The administration and the Federal Reserve would tell you that it's because of supply side problems. COVID interrupted the supply chain. You weren't getting electronic chips and all the rest of that and that's true, that that did curtail supply. But what they're not telling you is that their demand policies were just totally reckless. If you start with the Biden administration, they come into office March 2021. They pass a $1.9 trillion-dollar American Rescue Plan. That comes on top of $3 trillion dollars in bipartisan support. So, you get an increase in government spending of $5 trillion dollars, which is 20% of GDP. And the problem is that one had an output gap of something like 4, 5% at most.

The fiscal policy is excessive. Larry Summers, described that as, "The most irresponsible fiscal policy in the past 40 years." I would agree with that. Then have a Federal Reserve that they keep interest rates at zero. They buy bonds at a faster rate than Bernanke did in response to 2008. They buy roughly 4 1/2 trillion dollars of bonds in the space of 12 months. It took Bernanke six years to do that. They're letting the money supply balloon. The broad money supply, the last two years has increased by something like 40%. We haven't seen anything like this in 50 years.

So, it's no surprise that we've got this inflation. Now, we're getting hit by this Russian/Ukraine shock sending commodity prices through the roof. The number you saw, the 7.9%, doesn't incorporate the 70 cents a gallon increase in prices since the February 24th invasion. We're going to see inflation at 8 1/2, 9%. We're going to get to inflationary expectations unanchored.

The Federal Reserve, they've done two things by their reckless monetary policy. The one is they've produced inflation. But the second thing is they've produced asset price and credit market bubbles all over. Equities valuations are at a 100-year high, according to Case Schiller. Housing prices, even adjusted for inflation, we're above 2006 level. Then credit spreads narrowing like crazy. You've got a credit bubble. So that puts the Fed in a box now. You've got inflation out of control. It needs high interest rates. But high interest rates would kill these bubbles. So (laughs), they've really got a very delicate balance to do.

Larry Bernstein:

How do you explain the surge in inflation, I don’t think supply chain disruption is responsible for price increases across all products: housing, autos, wages, its everywhere? Why is the Biden administration sticking to the supply chain causality and the transitory nature of inflation?

Desmond Lachman:

That is politically what they have to do. Biden is having to pander to his progressive base. He does the expenditures and then he's going to somehow explain that the inflation has got nothing to do with him. It's either going to do with COVID or Putin. The Fed is a lot less excusable.

The Fed, their job is supposed to be price stability and they've made huge misjudgments. What we learned in the '70s and '80s was that monetary policy operates with long and variable lags. Here, we've got a Fed that is so data-dependent, they don't anticipate things occurring. March 19th, 2021, when Biden introduces this massive package, the Fed sticks to its same monetary policy. Really, it boggles my mind how incompetent this Federal Reserve has been. There's no excuse.

That inflation is the result of too much demand and too little supply. What they've done is that as the supply has gone down, they seem to have been increasing the demand either by ballooning budget deficits or by the Fed having its pedal to the metal. I don't see the logic of what they're doing.

They are talking about very gradual increases. Let's just look where interest rates are. Your interest rates at zero and inflation at seven.

But the point I'd emphasize is that for them to squeeze inflation out of this economy is not going to be easy because of the distortions not only in the United States asset and credit markets but it's a global. Federal Reserve along with the ECB, the Bank of Japan, the Bank of England. All of them doing the same thing, flooding the market with liquidity.

Larry Bernstein:

Any introductory macroeconomics textbook describes effective Keynesian economic policy when fiscal stimulus is applied counter-cyclically, but in the past year the Federal Government spent more money ever in a pro-cyclical action. The proposed Build Back Better bill would have added further stimulus of additional trillions. Other than Joe Manchin, every other Democratic member of the House and Senate supported the additional spending despite the Keynesian argument to cut spending. How do you explain the Democrats abandonment of Keynesian principles?

Desmond Lachman:

It's difficult. In the United States there's no constituency for sound public finances. Academics, they've been pushing this idea of modern monetary theory. Interest rates are low. You don't have to worry about budget deficits. Apart from Larry Summers, who got it right. But he was very much in the minority.

But the rules of economics don't change. I agree with you that without Joe Manchin, you would've had additional fiscal pressure. It just means that the inflation really gets out of control very, very soon.

Larry Bernstein:

Why weren't academic economists clamoring against increased spending given the economic strength and the supply constraints?

Desmond Lachman:

Academics got it terribly wrong in 2008, they didn't see that coming at all. So for the academics to get it wrong isn't that unusual. Many years of deflationary pressures, we've had China entering the global system, we've had technological progress at a very rapid rate putting downward pressure on prices.

So up until recently, all of the central banks had trouble getting inflation back to where they wanted it. You also had unusually low interest rates. You were at the zero bound. Inflation is so low, we can take risks on the side of inflation. We really don't want to go into this deflationary trap.

So that thinking was okay until you come to the pandemic and then you get the flood gates opening in a way that we've never seen before. Five trillion dollars of fiscal stimulus. When the gap is four percent, you're throwing 20 percent at it. It makes no sense. With monetary policy, what strikes me is you really don't get any mention of the money supply in any of the speeches that Powell gives.

They've really taken their eye off the ball. I have no idea what is the model that they're thinking. All I can say is they've got us into a huge inflationary mess and they've got us into a big equity, housing, credit market bubble. Not just in the United States but globally.

I think we're headed for a hard landing. It's just a question of what is the timing?

Larry Bernstein:

Milton Friedman said that inflation is always a monetary phenomenon. How does that explain the low inflation since 2008 and the rising inflation now?

Desmond Lachman:

When you look at money supply you've got to look at different kinds of money supply. You've got to look at very narrow money supply, what the base money that the Fed is creating, and broad money supply, what most people are holding. It's the broad money supply in Friedman's world that drives the inflation.

In 2008, the Fed did print a boatload of money, but the banks didn't lend that money. So the banks were holding the money, so you didn't get the broad money supply increasing like it did this time around. Now we had banks that were in reasonable shape, when COVID occurs, they get flooded with liquidity, so there's lending that goes on, so the money supply grows at a rate that we haven't seen before.

If you looked at the broad money supply in 2021, the increase is something like 25% in a single year. Generally, when you had peaks earlier, they would walk the order of eight, nine, 10%. You know, we hadn't seen 25%. So, it's an entirely different order of magnitude.

I'm not saying that I subscribe to Milton Friedman's view, because we found in the past that those aggregates weren't that accurate in predicting exactly what is going to occur. However, when I saw a chart showing that money supply is doing something it hasn't done in 50 years that's really literally off the chart, that there's too much money around and that's overheating and the inflation.

Larry Bernstein:

Any thoughts on tight labor markets further pushing up inflation?

Desmond Lachman:

You've seen wage pressures. Wages increasing now at a pretty rapid rate. Job openings at record levels. You've got too much demand and you don't have an adequate amount of labor supply.

And that the danger for the Fed is that if these inflation numbers go higher, then the inflationary expectations can get unanchored and then we can get into this whole wage price story that we've seen before in the 1970s.

Larry Bernstein:

Why was the Fed saying that inflation is transitory?

Desmond Lachman:

They stuck to that mantra for a long while that inflation was transitory, that's month after month when it proved that it was increasing. They've abandoned that position, so Powell has withdrawn the word transitory, he now realizes that he has to raise interest rates. Previously, they were saying there were going to be no interest rate increases, now they're saying they're going to be three interest rate increases. What they've done is they've stopped the purchasing of all of those bonds. All of that should have been done at least six months behind the curve.

They recognize now that they do have an inflation problem. But the reason that I don't see them moving that rapidly, the first is that we're in the middle of a war. There's a lot of uncertainty, you don't want to move too quickly, do something rash and then regret it.

But it seems to me that the bigger reason is that the financial markets look to me like they're beginning to unravel, so they realize that there are limitations on how much they can do.

If they totally remove the idea that there's a Fed put, that could be very dramatic in the market, so they're between a rock and a hard place. They've got this inflation problem, but they've got the financial markets to worry about.

My guess is that what they do is they increase interest rates, but at too slow a pace to make much of a difference to the inflation story. They just kick the can down the road, but what it means is that the landing will be harder when they eventually are forced to slam on the monetary policy brakes.

Larry Bernstein:
Mistakes were made, why not admit them and raise rates quickly and sharply and get us on the right course, why delay things and continue with too low of an interest rate?

Desmond Lachman:

I would say that part of his behavior last year has to be associated with wanting renomination, knowing that raising interest rates could jeopardize his renomination. And I think that that's rather shameful to create an inflationary problem for which we're now going to pay.

Larry Bernstein:

40 years ago, we had high inflation and Volker raised rates. How is it different this time around?

Desmond Lachman:

Well, I guess the way that I see the difference between 40 years ago is that we didn't have these asset and credit market bubbles. So the recession is likely to be deeper this time than a normal recession.
But I would agree that once you've let the inflation genie out of the bottle, as we certainly have, then you're not going to get the inflation down without a period of much slower growth. So the economy really has to slow down. It probably has to go into recession in order to bring the inflation down.

There's not a free lunch that if you screwed up, there's a price you pay, there's no magic way of wishing this away.

Larry Bernstein:

What do you think of Charles Goodhart's thesis that deflation was caused by the one-time addition of Chinese labor to the international economy and that is now over?

Desmond Lachman:

I agree with him that China was a big deflationary force. As we incorporated China and India into the global economy, that put downward pressure on prices. And that probably has run its course.

Where I disagree with him is that you can get other factors to exert downward pressure on wages and prices, and that is technological progress.

If we really are going towards greater robotics, artificial intelligence, 3D printing, in my lifetime, I've seen technological progress make a huge difference. And if this occurs at a faster rate, that can be your offset to the China situation.

Larry Bernstein:

How will higher interest rates effect different sectors of our economy?

Desmond Lachman:

Interest rates will work in a different way this time around, instead of it necessarily slowing the housing market, slowing the auto market, the channel this time around could be through the financial markets.

A lot of these bubbles that we're seeing in the equity, housing, credit markets are premised on the idea that we're going to have zero interest rates forever, and then we see that the interest rates are actually rising meaningfully, and that deflates the bubbles that's the way we'll get the economy slowing.

Larry Bernstein:

How do you explain the significant negative real interest rates in G7 government debt?

Desmond Lachman:

If you look at the ECB and the Fed, between them, they've bought $10 trillion of bonds. I don't know why one would be surprised that bond rates are that low. As the inflation goes, you might see something different.

The way I'm viewing the world is that I think the bond market has got it right that the short end of the curve is where the interest rate should go up, long should be down, because that seems to be, my view is that this is going to lead to all sorts of financial market dislocation. You get a deep recession, and then we back to the deflationary problem going forward. Short term, we are going to see inflation rise quite a lot.

I think that that's baked in the cake for a number of reasons. One is that this whole Ukrainian commodity price business that isn't in the numbers yet that can easily add alone one and a half, 2% to the inflation rate. Another thing on the inflation side is the housing component. You've got house prices going up by 20%, rents going up by 12%. And you look what they've got in the index, that goes up by three or 4%, so that typically works with a long lag. If you ask me where inflation would be the next six months, we've come pretty close to the 10% range.

But going forward, if we do have a 2008 kind of recession, then inflation's going to be the last of our problems. Nobody's really worried about the public debt anymore, and my experience has been that never ends well in the long, long run. You know, that generally, governments try to inflate this away.

Larry Bernstein:

Sounds like they are inflating it away right now.

Des, I end each episode on a note of optimism, what are you optimistic about?

Desmond Lachman:

I'm always reminded of Herbert Hoover's famous statement where he said, blessed are the children, they'll inherit the national debt. I don't think I'll be around to see the outcome of the real mess that my generation has made of the economies.

Larry Bernstein:

You need to work on your optimism Des.