THE WALL STREET JOURNAL.
The Wall Street Journal, May 23, 2023

Inflation Has Peaked—Get Ready for Deflation

Price increases would have eased without the Fed's tightening, which we will soon see was overkill.

By Donald L. Luskin

I explained on these pages 10 months ago "Why Inflation Is on the Way Down." That was precisely the top for inflation, with the consumer-price index up 9.1% on a year-over-year basis. It's now at 4.9%. Not every detail of my prediction has proved true, but in less than a year the CPI has made more than half its journey back to the Federal Reserve's target.

Today my worry isn't that 4.9% inflation is still too high; it is that inflation will fall below the Fed's target, and that about a year from now we will have outright deflation.

To understand why, remember that the Fed didn't cause the current bout of inflation. We've had zero interest rates before and held them there for 3½ times as long without inflation (2008-15). We've had quantitative easing before too, representing a larger share of the economy, and we kept it up for five times as long without inflation (2009-17). The record increase in the money supply caused by $6 trillion in pandemic relief payments in 2020 and 2021 unleashed the present inflation.

The aggressive tightening regime the Fed has undertaken, including an unprecedented four back-to-back 75-basis-point rate increases, deserves little credit for the recent decrease in inflation. The drop has been caused primarily by the sharp slowing in money-supply growth resulting from the end of federal pandemic stimulus payments.

It's all timing. The great monetary theorist Milton Friedman famously said "monetary actions affect economic conditions only after a lag that is both long and variable." Fed Chairman Jerome Powell has quoted Friedman on this many times.

Money-supply growth, driven by stimulus payments, peaked at 27% year-over-year in February 2021, the highest since 1959, when the data began. The payments wound down substantially in the third quarter of 2021 and ended entirely in the fourth. The 1½-year lag between the peak in money growth and the June 2022 peak in inflation is in line with historical experience.

In the fourth quarter of 2021 the Fed was still saying inflation was "transitory." It didn't lift off from two years of zero interest rates until March 2022—and that was a mere 25-basis-point hike. The Fed didn't really get into inflation-fighting mode until June 2022, with the first 75-basis-point rate increase—the same month inflation peaked at 9.1%. If the historical norm of approximately a 1½-year lag between policy and result holds, then we haven't begun to see any effects the Fed's actions have had on inflation since it started hiking rates 14 months ago.

So we shouldn't thank the Fed for the progress on inflation achieved so far, but we might soon curse it for going too far. With the cessation of stimulus payments, money-supply growth fell to normal levels—then into a contraction. That is due not only to the end of stimulus payments but also to the sharply higher interest rates engineered by the Fed, which younger generations of savers have never seen before.

Higher rates have caused the largest savers to shift from demand deposits, which are still paying near-zero rates at the large banks most people use, to time deposits, such as certificates of deposit, that pay closer to market rates. There is nothing wrong with a saver locking up his money for a year, but when a large saver does it, it is no longer counted as "money" in M2, the most commonly used measure of money supply, because consumers can't immediately spend it. When spending slows, all else being equal, so does inflation.

Slowing money growth now is interacting with higher rates, and the result is contraction. M2 has shrunk 4.63% in the past year. This is the only contraction in U.S. history, so there is a lot we can't predict here, but it would be extraordinary if such a contraction didn't result in deflation, just as the large money-supply increase two years ago resulted in inflation.

One might argue that after so much inflation, a little deflation wouldn't be so bad. But economists usually see deflation as the greater threat because it is easy for consumers simply to stop spending when they expect prices to fall. That is the kind of vicious circle that causes recessions. Because policy changes operate with lags, we won't experience deflation for months. When it arrives, it will be too late for the Fed to act.

In November the Fed executed the last 75-basis-point rate increase because it was starting to worry about the lagging economic effects of so much tightening. Because of these worries, over the next six months the Fed slowed the pace of hikes, making four smaller ones. Now Mr. Powell has hinted that there won't be more hikes, but the usual phalanx of Fed spokesmen are telling people not to expect rate cuts soon.

As always, the Fed is fighting the last war—an inflation war. It's time for the Fed to show real respect for the policy lags they already acknowledge and get ahead of the coming deflation.

Mr. Luskin is chief investment officer of TrendMacro.