The Market Oracle

The Great Inflation Canard

By Steve H. Hanke

April 2, 2015

Charles W. Calomiris and Peter Ireland, two distinguished economists and friends, wrote an edifying piece in The Wall Street Journal on 19 February 2015. That said, their article contains a great inflation canard.

They write that "Fed officials should remind markets that monetary policy takes time to work its way through the economy—what Milton Friedman famously referred to as "long and variable lags"—and on inflation." That's now a canard.

For recent evidence, we have to look no further than the price changes that followed the bursting of multiple asset bubbles in 2008. The price changes that occurred in the second half of 2008 were truly breathtaking. The most important price in the world — the U.S. dollar-euro exchange rate — moved from 1.60 to 1.25. Yes, the greenback soared by 28% against the euro in three short months. During that period, gold plunged from \$975/oz to \$735/oz and crude oil fell from \$139/bbl to \$67/bbl.

What was most remarkable was the fantastic change in the inflation picture. In the U.S., for example, the year-over-year consumer price index (CPI) was increasing at an alarming 5.6% rate in July 2008. By February 2009, that rate had dropped into negative territory, and by July 2009, the CPI was contracting at a -2.1% rate. This blew a hole in a well-learned dogma: that changes in inflation follow changes in policy, with long and variable lags.

Milton Friedman was certainly correct about the period covered in the classic, which he co-authored with Anna J. Schwartz: A Monetary History of the United States, 1867-1960. Recall that the world of that era was one in which the fixed exchange rates ruled the roost. That's not today's world. Indeed, many important currencies now float. Since the world adopted a flexible exchange-rate "non-system", changes in inflation can strike like a lightning bolt.

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