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Top economist Steve Hanke says the 'incompetent' Fed is on a fast track to cause a terrible recession

BY **SHAWN TULLY**

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Hanke is called the 'money doctor.'

ANDREW HARRER—BLOOMBERG/GETTY IMAGES

In the gray world of economics, few figures can match Steve Hanke for courting swashbuckling adventure. Hanke, professor of applied economics at Johns Hopkins University, has lived the most rollicking of times as a globe-trotting "money

doctor," killing the hyperinflations of developing, often wobbling regimes. When he persuaded Montenegro to dump the Yugoslav dinar for the Deustche mark in the late 1990s, Yugoslav dictator Slobodan Milosevic spread rumors that the economist was a French spy and dispatched a hit squad to assassinate him. Hanke won knighthood from post-Communist Albania by advising a zany, gun-toting economics minister, stopped roaring hyperinflation in Bulgaria, and oversaw the successful dollarization of Ecuador.

Doubling as a daredevil trader, he won a king's ransoms shorting oil in 1986, smashing the high-flying French "franc fort" in 1993, and presiding over an Argentine fund that was the world's top performer in 1995, and—lest the hit list flag—anticipating the spectacular collapse of the Russian ruble in 1998.

Despite a resume of exotic exploits, Hanke is a rock-ribbed traditionalist when analyzing the causes, and prescribing the solutions, to inflation. He's an adherent and arguably the world's leading champion, of the "monetarist" school, teaching that inflation is driven solely by changes in the supply of money. Selling that theory explains how he helped spread the pragmatic policies that forestall inflation in foreign nations. But early last year, he became focused on the U.S. It was then that he warned publicly that the Fed, by gunning the money supply, was pursuing precisely the policies that monetarism predicts will send prices rampaging, a scenario he'd seen play out in countries big and small.

Now, he warns that the central bank is so clueless that it has thrown everything into reverse, completely halting growth in the money supply for the last six months. According to Hanke, if this austere practice continues, it portends a severe downturn sometime next year. With inflation already entrenched in the gears of the economy, Hanke anticipates that we're facing a period of the long-feared "s-word," stagflation.

Hanke's early calls give him strong credibility, and the irrepressible economist is exploiting that newfound capital as a firebrand critic of the Fed's stance under chairman Jerome Powell. In a series of interviews with Fortune, Hanke left no element of the central bank's policies unscorched. "The Fed is just completely incompetent," he says. "They're not even looking at the money supply. They've created a huge surge in the money supply that's created inflation. Now, they don't want to admit that the money supply has anything to do with the outbreak, so they never mention the word 'money.' It's the great cancellation. They don't want the inflation noose around their necks."

Where the Fed went wrong on inflation, according to Hanke

Put simply, monetarism holds that a huge surge in the money supply will eventually trigger a surge in inflation. Hanke frequently cites the mantra of Milton Friedman, the legendary monetarist who emblazoned the theory's four-symbol formula [MV=PQ] on his red Cadillac's California license plate. "Inflation is always and everywhere a monetary phenomenon, in the sense that it can only be produced a more rapid increase in the quantity of money than in output."

Today, monetarism's Quantity Theory of Money is out of vogue, to put it mildly. Hanke is one of its relatively few exponents in academia, and during this period of newly-racing inflation, both the White House and the Federal Reserve are claiming that money supply growth played no role in birthing the problem, and don't raise the possibility that correctly managing M2, the Fed's broad measure of money, is the way to fix it. Its record of failure, Hanke says, shows that "the Fed is simply looking for inflation in all the wrong places."

Early last year, pre-Big Inflation, Powell stated on Congressional testimony that "The growth of M2 doesn't have important implications for the economic outlook." Ex post-Big Inflation's onset on September 8, at a Cato Institute conference, he updated his dismissal, declaring, "Monetary aggregates don't play an important role in our formulation of policy. And we don't think they are generally a good way to think about policy of inflation."

Powell's view chimes with his boss's thinking. In the spring of 2020, President Biden justified his blueprint for trillions of dollars in stimulus spending as a rejection of monetarism, stating "Milton Friedman doesn't run the show anymore."

Hanke saw the disaster coming early, and said so in a *Wall Street Journal* editorial in July of last year which he co-wrote with John Greenwood, his long-time collaborator, former chief economist at Invesco, and architect of Hong Kong's monetary regime. While the Fed characterized the then-spike in the CPI to around 5% as the "transitory" shock caused by supply chain disruptions, Hanke and Greenwood predicted inflation would reach between 6% and possibly as high as 9% by the end of 2021, and likely remain elevated into 2024.

The CPI ended last year at 7%, and this year stayed at the top end of Hanke's range, settling at 8.3% in August. Former Treasury Secretary Larry Summers also issued a

sage early inflation warning, but Hanke and Greenwood were practically alone in putting a number on their forecast, and they hit the bullseye.

The Fed's on track to force an unnecessary recession, Hanke charges

That Hanke's forecasts are proving so prescient makes it important to heed the warnings he's issuing right now. It's reasonable to debate exactly what influence the money supply exerts on inflation, but the recent experience, and past episodes, suggest it's highly important, if not the only driver. In a recent interview with *Fortune*, Summers backed the conviction that by flooding the economy with trillions in new money, the Fed stoked the CPI, even deploying a favorite Hanke metaphor of a monetary "bathtub" that when filled too high, overflows into inflation.

Frankly, what the Fed's been saying doesn't seem to make sense. It stretches credulity by denying that jacking up the money supply played any part in triggering the crisis. Here's what should worry all Americans: Our central bank denies that jacking the money supply played *even a small part* in causing the crisis, when the real world evidence––not to mention common sense––strongly suggests that it was an important factor. So, shouldn't we fret that Powell's plan for mending it, which also ignores M2, will backfire big time?

Hence, this writer sought Hanke's view on how ignoring this crucial monetary force got us into this mess, and whether the Fed's newly super-hawkish strategy is pushing the U.S. into a recession that wouldn't be inevitable at all if its policymakers were heeding the influence of opening and closing the money valve right now.

Hanke opened by reviewing what he considers monetarism's flawless record of forecasting the trajectory of prices in past inflationary episodes, and how its principles are proving farsighted once again. "There has never been a significant inflation, with prices rising 4% per year for two or more years, that was not preceded by significant growth in the money supply," he declares. He adds that the immense buildup in the monetary bathtub means the excess must drain off via inflation, and that the process will take a while. "We're stuck with elevated inflation into 2024," he says. "There will still be a huge monetary overhang that has to be worked off. People are still holding 20% more money relative to their incomes than is normal because of all the money supply creation, and those balances will be spent down, bringing more inflation. There's nothing the Fed can do about that

now." He predicts that year-over-year CPI will ease only slightly to between 6% and 8% by the close of 2022, and end next year at around 5%, still more than double the Fed's 2% target.

Now, Hanke warns that the Fed's adopted the wrong regimen for a cure, once again shunning the pivotal impact of M2. The two sources feeding M2, or the monetary aggregates, are money created by banks via new lending, and dollars minted by the Fed via "quantitative easing" (QE) or purchasing securities held by individuals and non-bank institutions that give sellers cash that they spend. From early 2020 to until around March of this year, banks were lending at a rapid pace on everything from mortgages to credit cards, and the Fed added over $4 trillion to its balance sheet buying bonds, padding consumers' wallets and sending too many dollars chasing too few goods. Between the two founts, the money supply grew by $6.3 trillion or over 40%, at an annualized rate of roughly 16%.

It was the M2 blowout that saddled the U.S. with 8%-plus inflation. By Hanke's estimate, three trillion in excess dollars are still sloshing around in the monetary bathtub, the overage that will spill forth to keep the price level elevated into 2024.

But in the last six months, he says, money supply growth has collapsed from double-digits to zero. Bank lending has slowed as the economic picture darkened—we've seen it in the home loan market for months—and the Fed has reversed QE to sell mortgage-backed securities, and allowed its holdings of Treasuries to run off without replacing them. In that process of Quantitative Tightening or QT, folks trade spendable cash for bonds, reducing their purchasing power and shrinking the money supply. The net effect of the QT launch and slowdown in borrowing sent M2 from explosive expansion to a standstill in a sudden, jarring downshift.

For Hanke, a policy that takes M2 growth to zero spells disaster. One of the Fed's mistakes, he insists, is relying too heavily on interest rates to tame inflation. "Interest rates are only important in how they influenced the money supply," he observes. "They are an extremely imprecise instrument, and the impact of raising rates on M2 is highly unpredictable." Hanke asserts that in periods of strong animal spirits, when companies and consumers are optimistic about the future, they'll keep borrowing and spending heavily even when rates rise quickly. By contrast, when enterprises and families fear the worst and hunker down, a rise in borrowing costs can pummel spending and send the economy into a tailspin. That appears to be what's happening now, and it's especially a threat, says Hanke, when the central bank is also engaged in shrinking its balance sheet under QT.

Hence, the Fed's policies are crushing demand by taking M2 from the fast lane to a stall. And, says Hanke, it's oblivious to how severely its policies will batter the economy in the months and years ahead. "Powell acknowledges that he has no idea if the Fed's interest rate and QT policies will put the economy into a recession," says Hanke. "But what he's doing leaves no chance of the soft landing that Powell says is still possible. The Fed overdid it to begin with by pushing excessive monetary growth, and now they're doubling-down on overdoing it by tightening too much. That's steering the economy towards one whopper of a recession."

The Fed could avoid a recession, says Hanke, by carefully managing M2. In Hanke's monetarist playbook, ensure the economy keeps growing requires a constant, moderate increase in the supply of money, by his reckoning, around 5-6% per year. "Increasing M2 when you already have lot of excess money means inflation will drain off more slowly," he notes, "But not too much more slowly because the economy will avoid a downturn and produce more goods and services. Increasing M2 is crucial to keeping the economy growing smoothly."

Hanke, a veteran amateur aviator, compares the Fed's task of keeping the economy chugging to the pilot's challenge in maintaining an aircraft's proper elevation. The dial showing the plane's height is the altimeter. The economy's altimeter, says Hanke, is the money supply. It alone determines the level of inflation. "But the Fed doesn't even have the money supply on its altimeter," he asserts. "That's why they're flying blind." The correct course is keeping hands on the joystick, and "moving it carefully forwards and backwards" to achieve a balance between money creation by the banks and the Fed so that M2 rises at a slow but steady pace. By ignoring the money supply altimeter, says Hanke, it looks like the Fed is sending the economy towards a crash landing.

It especially irks Hanke that Powell is invoking Paul Volcker, the famed Fed chair and friend of Hanke's who famously conquered skyrocketing inflation in the early 1980s, to justify his own course of action. "He's saying, 'I'm Paul Volcker, I'm going to kill this thing,'" says Hanke. "Volcker was a monetarist who had the money supply on his altimeter, and said there was a strong linkage between M2 and inflation. Now, Powell is using Volcker as a crutch when he's spent his entire tenure trying to kill monetarism."

How deep and long will a recession go?

So what lies ahead? Once again, Hanke believes that the inflation schedule's already locked in, and that though the trajectory will gradually trend downwards, prices will still be waxing at a formidable 5% by the close of next year. The big question, the piece so uncertain in severity and timing, is what happens to the economy. For Hanke, it's crucial to understand the lag between sustained changes in the money supply and their impact on the real economy. That span is typically six to eighteen months. So what's happening today with M2 will guide GDP growth at some time during that window. The change in M2 consists of two parts, and the interaction between the two will determine the future course of M2, and the course of the economy.

The first component is what the Fed controls, namely, the Fed's contribution to M2. The second component is what commercial banks contribute via their lending and credit. In the last six months, the Fed has been shrinking the money supply, but bank lending has been positive. "In fact, thanks to bank lending, the Fed's negative contribution has been offset. But what worries me is that in the last 6 months, M2 has not grown." says Hanke.

We know what the Fed plans to do with QT and the Fed Funds rate, based on its statements and the big crunch since April. The uncertainty surrounds what occurs in the private sector portion, in banking. "If credit stays positive and is just enough to blunt the Fed's negative contribution to M2, the money supply will flatline and we'll have a recession," warns Hanke. "And it will happen sometime within that 6 to 18 month window. Keep in mind that M2 growth went to zero in April, so the timeframe for a downturn is now between October of 2022 and October of 2023." But the bank lending that's a positive, countervailing force has been falling in recent months. Say that continues. "In that case, money supply growth would go negative. Instead of a milder recession that would accompany zero M2 growth, you'd get a recession much sooner that's a lot more severe," Hanke notes. "The Fed's policies are bad to begin with, but what makes them worse is the unknown reaction of the banking system to an increase in the fed funds rate, and whether that will result in a contraction in bank lending that could worsen and extend a recession."

Since we know from the monetarist canon that high inflation will rule through 2023, we could well be stuck with both a deep recession and a surging CPI for all of 2023, if the banks retreat. That's the stagflation scenario everyone, including the Fed officials, so dread. But as Hanke points out, the Fed itself is steering us towards that crash landing. And for Hanke, it's something of a suicide mission.

He'd just love to see the Fed putting the monetary altimeter back on the dashboard, watching it closely as the guiding star, and gently working the controls to get the economy's wings level. That's what a good pilot would do. But for Steve Hanke, we simply don't have one.

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