Why Central Banks Keep Misjudging Inflation.

Quite apart from the debatable link between unemployment and inflation, a recurrent feature of business cycles is that the labor market lags behind demand and output, and demand and output, in turn, lag behind asset markets and developments in the banking system. Particularly important, in my view, are developments in the banking system that affect the rate of growth of the quantity of money, broadly defined. If central banks insist on putting the labor market at the heart of inflation forecasting, they will be caught out time and again. The lags are so short that they will have to forecast the unforeseeable.

This is not a mere assertion. It is the hard-won lesson of monetary history, repeated across cycles in the United Kingdom, the United States, and the euro area. Central bankers, mesmerized by Phillips-curve relics and real-time labor market data, have repeatedly misread the inflationary pressures building in the monetary sphere. By the time unemployment begins to fall, or wage pressures emerge, the monetary horse has long bolted.

Consider the transmission mechanism. Expansive banking behavior, whether through lower lending standards, quantitative easing operations, or regulatory easing, drives rapid growth in broad money (M4 in the UK, M2 or M3 equivalents elsewhere). This first manifests in asset markets: equities surge, property prices accelerate, and bond yields compress. These wealth effects then stimulate demand for goods and services. Only later, often with a lag of several quarters, does the pressure reach the labor market in the form of tighter conditions and rising pay settlements. Inflation itself, properly measured, follows with yet further delay.

The sequence is not mechanical, but it is reliable enough to guide serious policy. Broad money growth in the major economies surged after 2008 and again after the 2020 pandemic response. Asset prices responded almost immediately. Demand and output recovered with a lag of one to three quarters. Labor markets tightened later still. Yet many central banks, fixated on "maximum employment" mandates or NAIRU-style models, treated the early monetary surge as benign or even desirable. When inflation finally appeared, with a vengeance in 2021-22, they were forced into emergency rate hikes that could have been avoided with earlier, money-based restraint.

Critics will protest that the link between money and inflation is "unstable" or "long and variable," echoing the familiar Milton Friedman phrase often misapplied. But the instability is largely of the authorities' own making. When central banks allow broad money to surge without countervailing action, and when governments simultaneously expand fiscal deficits financed by bank credit creation, the monetary impulse becomes overwhelmingly powerful. The lags may vary in length, but their direction is consistent: money leads, activity follows, and the labor market brings up the rear.

This has long been the primacy of broad money in monetary analysis. Narrow measures such as bank reserves or central bank balance sheets are useful for operational purposes but tell us little about the economy's ultimate spending power. It is the quantity of money held by households and companies, including notes, coins, and sight and time deposits, that determines nominal demand. Neglect of this quantity, especially its growth rate relative to the sustainable growth of real output, lies at the root of repeated forecasting failures.

The policy implication is clear. Central banks should restore monetary aggregates to the center of their analytical framework. Inflation targeting, while useful as a discipline, becomes dangerously myopic when it relies on backward-looking labor market indicators. Forward-looking indicators of banking behavior and broad money growth provide far better early warnings. If money growth is accelerating sharply while asset prices are buoyant, the presumption should be that inflation risks are rising, even if unemployment remains above some arbitrary threshold.

Recent events underscore the point. The post-pandemic monetary surge was evident in the data by mid-2020. Asset markets surged. Yet many commentators and officials downplayed the risks, citing “slack” in labor markets and “temporary” supply disruptions. By the time those labor markets tightened and wage data began to flash warnings, inflation was already entrenched. The subsequent policy correction was necessary but came at a higher cost than a money-guided approach would have required.

No serious economist denies that labor market conditions matter. But they are an effect, not a cause, in the monetary transmission process. Placing them “at the heart of inflation forecasting” is to mistake the symptom for the disease. Central banks that persist in this error will continue to be surprised by inflation surges and will impose unnecessary volatility on the real economy.

The solution is not to abandon inflation targets but to enrich them by adding a monetary pillar that includes regular, transparent monitoring of broad money growth and developments in the banking system. Only then can policymakers anticipate rather than react. The lags may be short, but they are knowable. It is time to stop pretending otherwise.