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Dealing with inflation, really

The causes for inflation vary. But the economics profession's inability to think beyond crude analyses of inflation leads to crude policies to stem it

The inflationary wave has revealed all sorts of things about governments but also, more tellingly, about economists. The number of economists, and consequently policy-makers, who remain wedded to the unyielding idea that inflation results from too-loose monetary policy — hence central banks should restrict the money supply and raise interest rates — is legion. It has become what JK Galbraith would have called the 'conventional wisdom'.

It is still wrong. The causes of inflation vary by context and period. Tighter monetary policy is a blunt tool which risks generating recession and unemployment — harming workers even more than price increases. And besides this human suffering, if the drivers of inflation lie elsewhere, reducing the excess demand purportedly at fault will not even resolve the problem.

These obvious facts seem almost forgotten in mainstream discussion. Even the respected economist Olivier Blanchard, in a series of tweets, suggested that increasing unemployment was the only way to control inflation. The problem, apparently, was how to get workers to understand and accept this:

'One thought about inflation fighting. 1. When inflation comes from overheating, convincing workers that the economy needs to slow down, and that unemployment has to increase to control inflation, is hard but at least the logic can be explained. 2. When inflation comes from an increase in commodity and energy prices, convincing workers that unemployment has to increase to control inflation, is even harder. "Why should I lose my job because Putin invaded Ukraine?" 3. This makes the job and the communication strategy of central banks very hard indeed.'

Unit labour costs were responsible for less than 8

Leave aside the highly problematic assertion that 'unemployment has to increase to control inflation', which has been effectively refuted,

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conceptually and empirically, over the past two decades. Consider only the possibility that the driver of price rises is not 'excess demand' or workers demanding higher wages because they are not being adequately 'disciplined' by unemployment, but corporate profiteering, along with financial speculation in commodities markets.

There are good reasons to believe this is the case, especially in global markets and in the advanced economies. (In many low- and middle-income countries, the causes of inflation are more complex and mostly come from cost-push factors, including imported inflation from global prices and currency depreciations.)

Corporate profits

In the United States, for example, the Economic Policy Institute has shown that increasing corporate profits have contributed disproportionately to inflation. From the second quarter of 2020 to the last quarter of 2021, corporate profits were responsible for 54 per cent of overall inflation — a dramatic increase from the 11 per cent they accounted for in the previous four decades (1979-2019).

By contrast, unit labour costs were responsible for less than 8 per cent of the inflation, compared with 62 per cent in the previous four decades. Indeed, because of the recent price rises, the real value of the federal minimum wage is now at its lowest point in 66 years! The contribution of *non*-labour input costs — the famous 'supply-chain issues' so widely advertised — was 38 per cent, compared with 27 per cent in the earlier period.

Companies' ability to raise profit margins could itself be due to increased demand. Pent-up demand from households unable to spend much during the pandemic could have had an effect, especially given the very large fiscal stimuli of successive US administrations.

But a much bigger role was played by growing concentration and monopoly power in industry. Massively increased corporate profits were most evident in energy, food, and pharmaceuticals, as the supply shortages resulting from the war in Ukraine became convenient excuses for disproportionate price increases.

Strong predictor

Research by the Roosevelt Institute shows that in 2021 firms in the US increased their mark-ups and profits at the fastest annual pace since 1955, taking both to their highest absolute levels since that booming postwar decade. The researchers note that pre-pandemic markups were a strong predictor of mark-up increases in 2021, making market power a significant driver of inflation.

While the public perception of the current food crisis is all about war-related supply shocks, again company behaviour has proved more significant. The major grain-trading agribusinesses experienced dramatic increases in profitability in January-March 2022. They raised their prices without being questioned — everyone assuming this to be the result of war-driven shortages.

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Financial speculation, such as in wheat futures, drove up prices even in spot markets and the recent decline in wheat prices similarly reflects changes in futures contracts. (This is typical of speculative bubbles, which while often driven by news also tend to be affected by herd behaviour rather than real-world events.)

Such increased speculative activity is confirmed by important work by Agarwal, Lei Win, and Gibbs, who have tracked the activities of financial investors (investment funds in particular) in commodity markets. They find that, for example, 'in the Paris milling wheat market, the benchmark for Europe, speculators' share of buy-side wheat futures contracts has increased from 23 per cent of open interest in May 2018 to 72 per cent in April 2022'. Similarly in May 2022, speculators' long positions (buying positions) constituted over 50 per cent of open interest in Hard Red Winter and Soft Red Winter wheat varieties.

Regulatory action

If recent global price increases — which then translate into inflation of varying extent in different countries — are driven by such factors, then the policy response should be very different from the blunt instrument of aggregate monetary policy. It should instead focus on regulatory action to curb monopoly power and financial speculation. Taxation of excess profits could be a deterrent to such behaviour in future, but specific actions to control prices of strategic commodities also have a role, as Isabella Weber noted. Those who have pilloried such policies appear to be unaware of both history and wider experience.

The paucity of creative thinking about the causes of, and responses to, inflation reflects the sorry state of the economics discipline. It is likely to have severe consequences, economically and politically.

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