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The real drivers of inflation

The ECB is fighting inflation with interest rate hikes — putting the main burden on workers. But the causes of inflation lie outside the labour market

Silicon Valley Bank (SVB) collapsed on Wednesday 10 March 2023. A mere 48 hours passed between the bank's announcement that it was in trouble and investors emptying their accounts. But the main reason was not bad loans, as in the financial crisis of 2008. SVB had not put its money in highly risky assets but in supposedly safe US Treasury bonds. Rapidly rising interest rates as part of the US central bank's (the Fed) anti-inflation policy led to bond markdowns. SVB customers that had previously enjoyed surplus liquidity needed cash to restore liquidity and SVB had to sell bonds at a discount to obtain it.

SVB's bankruptcy was orchestrated by winding up Silvergate Bank and Signature Bank. The emergency sale of major Swiss bank Credit Suisse led to worries of contagion with the rest of the banking sector. Massive state intervention was required to avert its looming insolvency.

Price controls – but only for labour

While one is the result of 'blind spots in banking oversight', as the head of the *DeutscheBundesbank* ('German Federal Bank') put it, the others are victims of the monetary policy of central banks. Almost every week, the chief economists of the European Central Bank (ECB) and national central banks threaten further interest rate rises. Interest rates have been hiked six times since July 2022. The Bank of England raised its interest rate in February for the second time in two months, as did the Fed. Nevertheless, EU inflation remains more than three times higher than the European central banking system's two-per cent target. Core inflation has been rising steadily. This could indicate that inflation will continue longer than previously thought.

But what underlies this seemingly quixotic strategy? Rising interest rates entail a fall in value of bonds already in the market. Member States thus face further increases in government debt because of the rising interest

burden on new debt as well as the loss of bond values. Clearly, the ECB assumes that deviating from the path of raising interest rate could signal its concerns about its banks. ECB representatives have thus tirelessly reassured the markets that European banks' capital and liquidity positions are robust. Interest rates are set to peak at a 4 per cent base rate in September 2023.

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Although there is an agreement that inflation rates must be lowered, as things stand, this appears to mean – rather one-sidedly – that price controls are a good thing, but only for labour. For example, the Governor of the Bank of England called on workers to exercise wage restraint. The principle appears to be 'let the workers suffer while I sit in my castle on a pile of gold'. Interest rate rises are supposed to curb inflation and bring about lower, stable prices. The private sector is to receive financial support; no one wants another financial collapse along the lines of 2008. Nevertheless, unemployment could rise, despite the reported skilled labour shortages. Rising interest rates, in any case, harbour the risk that unemployment could rise in the medium term and living standards could fall.

In fact, it isn't really a matter of whether interest rate rises will lead to economic cooling and thus to falling inflation, but rather whether, as a result, inflation in the labour market is exacerbated or mitigated. If the response to price increases is wage increases and thus the so-called wage–price spiral sets in, as seen in the 1970s, the answer is the former. But such a correlation is not evident. Rather, wages are lagging behind price increases, which means that employees are unable to protect their real incomes.

What really drives inflation?

That is because the causes of inflation lie outside the labour market. Economist Joseph Stieglitz has shown in a study that current inflation is clearly supply- and profit-driven. This can be traced back to supply chain difficulties, sector-specific shortages of energy and agricultural products caused by the pandemic and the war in Ukraine. In these circumstances, central bank monetary policies may prove inadequate: 'Just because the US Federal Reserve has a hammer, it shouldn't go around smashing the economy' wrote Stiglitz .

As supply tightens, higher interest rates stifle necessary investments. Economist Grace Blakeley argues that sometimes the cure, whereby unemployment has to be accepted as a necessary evil, is worse than the disease. For example, a study from 2022 entitled *Who Killed the Philips Curve? A Murder Mystery* shows that in the 1970s, 87 per cent of the fall in inflation was not down to interest rate policy but rather trade union repression. The real drivers of inflation are companies' rising profit margins – in other words, windfall gains – as well as high energy prices. Curbing energy prices would bring down inflation. We are thus facing a price–profit spiral.

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Monetary policy here is not enough. Nevertheless, the central banks are doggedly pursuing traditional monetary doctrine, according to which interest rate policy regulates inflation. Choking off investments that are essential for economic transformation and for developing green energies is just inevitable collateral damage. Besides their indirect effects, high interest rates also directly exacerbate existing inequalities. Those with little or no wealth have more liabilities than assets and, therefore, high interest rates hit them harder.

Central banks are hindering key investments with this almost destructive policy of interest rate hikes. History seldom repeats itself but it does rhyme. Such a rollercoaster ride from Draghi's expansive monetary policy ('whatever it takes') with zero or negative interest rates to a policy of interest rate increases reminiscent of the 'Volcker shock' damages investment certainty and trust in banks. Rising inflation rates, a war and high energy prices form an initial situation similar to that of the 1970s, when the world was plunged into deep recession. At that time, shock therapy to combat inflation lacked the necessary instruments and scope. The ECB should therefore pursue an innovative, more balanced approach.

Because monetary policy instruments are not sufficient to solve the Eurozone countries' structural problems and rectify the monetary union's shortcomings. Monetary policy integration in the Euro area is not enough to ensure the stability of the currency area, with its strong fiscal decentralisation, economic contradictions and political fragmentation. But the ECB's mandate has been modernised at least in some areas, such as climate. This topic has recently come to the fore in the evaluation of financial stability and the effectiveness of monetary policy. In contrast to the Fed, however, the employment situation plays

no role here.

Reaching a compromise among the EU Member States on changing the EU treaties so that price stability is not the only main aim of monetary policy appears to be difficult or even impossible. But the ECB's mandate is set to be regularly reviewed with reference to the changing economic environment. Such future evaluations of ECB monetary policy strategy are to be welcomed.

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This needs to be supplemented by a well-calibrated fiscal policy for the EU and its Member States. The EU Recovery and Resilience Facility could form the nucleus of a common fiscal policy. Trade unions no longer accept the principle that price controls are fine but only for workers within the framework of collective bargaining.

Price interventions and competition law measures against excessively high prices resulting from abuse of market power in the commodity sector as a whole – oil, gas, basic foodstuffs –are the tools of choice. The fact is that inflation is much lower in Member States with direct price intervention than in countries in which mainly income-related measures have been taken. Austria has directly clamped down only on electricity prices. Its other support measures rely on income-related instruments, such as one-off payments. Only 25 per cent of its measures are aimed at bringing down prices and its 11 per cent inflation rate (as of February 2023) makes Austria the worst performing country in the Eurozone, in contrast to the 'winners', whose inflation rate remains at around 9 per cent. France's inflation rate is 7 per cent and 92 per cent of its measures are price-related.

An innovative rather than an orthodox monetary policy with the focus on boosting investment and employment is one thing. But this has to be supplemented with public policy measures at the Member State level, including a gas price cap, an uncoupling of electricity prices from gas prices, rent caps and especially a levy on excess profits – both within the framework of competition law and through a robust excess profits tax.



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