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CAPAIAN : Inflation is not (just) a matter of supply chain disruptions | Free Malaysia Today (FMT)

Inflation is not (just) a matter of supply chain disruption

According to economic affairs minister Mustapa Mohamed, the current rise in inflation is a global phenomenon caused by supply chain disruptions and high energy costs.

Unfortunately, many other political leaders around the world support the same view. However, such a position is a way to hide the real culprit behind inflation: money creation.

1. What is inflation?

When we think about the word inflation, our mind immediately goes to an increase in the price level and, after that, we figure out that our purchasing power is deteriorating, that somehow we are poorer.

Traditional textbooks distinguish between demand-led inflation and cost-push inflation. The first case is one of an excess of aggregate demand caused by an increase in the total demand for goods and services.

It is such that the aggregate demand is above the potential production capacity. According to the same textbooks, this can be the case, for example, of an increase in consumption, an expansion of credit or deficit spending.

Cost-push inflation, instead, would be an increase in prices due to an increase in the costs of production factors that are higher than the increase in their productivity.

However, such definitions can be considered a misuse of the term inflation. It is true that policymakers find it easier to accuse businesspeople, trade unions, or even consumers for inflation.

But all "these can produce high prices for individual items; they cannot produce rising prices for goods in general. They can cause temporary ups or downs in the rate of inflation. But they cannot produce continuing inflation for one very simple reason: none of the alleged culprits possesses a printing press on which it can turn out those pieces of paper we carry in our pockets; none can legally authorise a bookkeeper to make entries on ledgers that are the equivalent of those pieces of paper" (as written by Nobel laureate Milton Friedman).

Instead, inflation in its "original and proper meaning is an excessive increase in the quantity of money, leading in turn to an increase in prices" (F A Hayek).

This clarification is very important, in particular today, when monetary and political authorities keep on blaming supply-side shocks (in turn generated by Covid-19 responses such as stay-at-home orders) for the price increase we are experiencing, with no mention about the increase in money supply beyond the rate of growth of output, generated by

policies implemented to address the scars created by those stay-at-home orders, namely government deficit spending and expansive monetary policies.

Therefore, we may say that inflation is produced by “a more rapid increase in the quantity of money than in the quantity of goods and services available for purchase”, and such an increase raises prices in terms of that money (Milton Friedman).

2. The monetary nature of inflation

The relationship between the increase in the quantity of money (higher than the increase in output) and rising prices is thus crucial for the proper definition of inflation.

As explained by another Nobel Laureate, F A Hayek, “a general rise in prices, for instance one brought about by a shortage of food caused by bad harvests, is not inflation. Nor could we properly call “inflation” a general rise in prices caused by a shortage of oil and other sources of energy that led to an absolute reduction of consumption, unless this shortage had been the pretext for a further increase in the quantity of money. There may also be inflation that considerably harms the working of the market without any rise in prices – if the rise is prevented by controls. Indeed such “repressed” inflation tends to disorganise economic activity even more than open inflation”.

Therefore, inflation “occurs when the quantity of money rises appreciably more rapidly than output, and the more rapid the rise in the quantity of money per unit of output, the greater the rate of inflation” (Milton Friedman).

In a nutshell: the only cause of inflation is too much money chasing too few goods.

It is also important here to repeat that today, “when the commonly accepted media of exchange have no relation to any commodity, the quantity of money is determined in every major country by the government. Government, and the government alone, is responsible for any rapid increase in the quantity of money” (Milton Friedman).

3. Covid inflation

The rise in prices emerging with the post-lockdown economic recovery can be easily explained within this framework.

All governments increased their expenditure significantly in an attempt to fight the spread of the virus and support the health of their people at a time when there had been no increase in taxation to finance it.

The result was an increased borrowing requirement which many countries chose to support by increasing the money stock (M). At the same time, stay-at-home orders, lockdown and suppression policies slowed the velocity (V) of circulation of money.

The immediate effect on monetary demand M x V was indeterminate, with stock rising but flow declining. However, as countries moved back towards some type of normality, so did velocity and monetary demand began to increase and they outpaced a stagnant economy.

Given a time lag which may be 12-24 months from the time of the increase in money stock (lengthened due to a temporarily slowed velocity), we can confidently expect inflation to increase in a stagnant economy, giving countries a period of stagflation.

The inflation occurring now was caused by the excessive expansions in monetary demand which started last year.

However, governments and central banks wish to absolve themselves of the responsibility for this inflation in the same way that they did in the 1970s. They pick on the prices that are going up most in the basket used to measure inflation and draw attention to them as a cause.

This is the cost-push myth rising again. Higher oil prices, energy, food, transport costs, and supply chain hiccups are not the cause of inflation. They are the symptoms.

How long will the current higher than target inflation continue? The answer is simple.

It is for as long as the growth in monetary demand is faster than the growth of output, thus causing the average level of prices to adjust upward.

We must not confuse the changes in relative prices that occur all the time with the cause of a change in the average level of prices.

Not recognising this will impede the ability to properly identify the causes of inflation and, therefore, to address it. It goes without saying that policymakers are quite reluctant to accept responsibility for producing inflation, and indeed they tend to find some different excuses.

As previously mentioned, in the current scenario, politicians blame supply-side disruptions for the growing level of inflation. In other situations, they have found it easier to accuse businesspeople, trade unions, or even consumers for inflation.

But all "these can produce high prices for individual items; they cannot produce rising prices for goods in general. They can cause temporary ups or downs in the rate of inflation. But they cannot produce continuing inflation for one very simple reason: none of the alleged culprits possesses a printing press on which it can turn out those pieces of paper we carry in our pockets; none can legally authorise a bookkeeper to make entries on ledgers that are the equivalent of those pieces of paper" (Milton Friedman).

4. A painful way out

When inflation is out of control "we will come to see our salvation as residing in the use of power. Power is always sought to promote the good, of course, never the bad. We are being bombarded with increasing intensity with calls for income policies, price and wage controls, national planning, and the like. Each of these aims to achieve its objectives by the imposition of new restrictions on the freedom of individuals" (James Buchanan and Richard Wagner).

Instead, action on the quantity of money should be taken. While stopping the growth of money, an impending deflation should also be prevented and such an intention should be announced in order to avoid the recession to degenerate into a depression.

Secondly, the primary aim should be the stability of the value of money. This means bringing about a reduction in the rate of monetary growth, but this entails a problem of political will.

In fact, a slower rate of monetary growth following a period of inflation will generate lower economic growth and unemployment. Slower growth and higher unemployment are not cures for inflation, they are side effects of a cure that wishes to be successful.

Because of the presence of these side effects, it is important to slow inflation gradually but steadily.

The best way to do so is, obviously, limiting government spending. In this regard, the simplest rule is to re-establish the primacy and superiority of balanced budgets, which will finally destroy the unhealthy belief in the existence of free lunches.