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Inflation, Central Banks, and Monetary Policy

Prices and inflation

Every marketed product has a money price, measured in units of currency (dollars, pounds, and so on). These prices help buyers to compare one commodity to another. When a shopper goes looking for a bargain, they compare prices of different brands to see which one offers (in their judgement) the best deal. When comparing prices of different commodities, we are examining RELATIVE PRICES: that is, the price of one commodity relative to another. In this comparison, it doesn't really matter what currency is used, or whether we measure prices in dollars or cents. It is the *ratio* of prices, not the prices themselves, that is most interesting. A bottle of fine chardonnay costs three times as much as the cheap house white; a passenger car costs 20 times as much as a high-definition TV set; a detached home costs four times as much as a small condominium. For this purpose, you can choose any standard of measure.

Relative prices change over time, reflecting the changing conditions of production of different commodities. Technological breakthroughs which make it less costly to produce certain commodities usually lead to declines in their relative prices. For example, prices have declined quickly for personal computers and other electronic products in recent decades for this reason. Changes in the intensity of competition in particular industries can also change their relative prices, by affecting the "normal" rate of profit paid out in those industries.

In contrast, absolute prices are simply the actual numbers attached to prices. And the PRICE LEVEL is the overall level of absolute prices prevailing in an economy. Suppose that suddenly, every store in the country began to label prices in cents (or pence), rather than dollars (or pounds). Prices would suddenly *seem* much higher. But at the same time everyone now receives their income in pennies. Suddenly, their wages and salaries look much bigger, too.

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Has anything changed? Not really. All relative prices are the same. And the purchasing power of wages and salaries is the same. So people aren't any richer (by virtue of their "high" incomes), nor are they any poorer (because of "high" prices). But the absolute price level (quoted in cents now, rather than dollars) is 100 times higher than it used to be – since the absolute number describing each price is 100 times larger.

The most common reason for a change in the absolute price level is **INFLATION**. Inflation occurs when the average level of prices in the economy increases over time. Even as overall prices are increasing, particular *relative* prices will change. Prices of some commodities will increase more slowly than average (thus becoming less expensive in relative terms), while others increase more rapidly (becoming relatively more expensive). For a few commodities (like electronics), prices might decline in absolute terms despite the rise in the overall price level. These products thus become doubly inexpensive in relative terms – since their absolute prices are falling while most other prices are rising.

DEFLATION is also possible if the absolute price level *declines* over time. Deflation usually occurs during severe economic recession or crisis, when banks contract credit and businesses are desperate to sell products. Deflation has disastrous consequences, including escalating debt burdens for households, businesses, and government.

The real price of any commodity is its price adjusted to reflect any change in the overall price level. A commodity's real price is therefore its particular relative price compared to the general level of *all* prices. A commodity's real price goes up if its absolute price (measured in dollars) rises faster than the overall price level.

Other economic variables can also be measured in real terms. For example, suppose that workers receive a 5 percent increase in their wages. But at the same time, suppose that overall consumer prices also grew by 5 percent. **REAL WAGES** – that is, the purchasing power of wages – haven't changed at all. Wages measured in dollars (known as **NOMINAL WAGES**) must grow faster than consumer prices for workers to experience any improvement in real purchasing power.

Interest rates, too, should be measured in real terms, as the difference between the nominal interest rate (in percent) and the rate of inflation. If a bank charges 5 percent annual interest for a loan when overall prices are also growing at 5 percent, the bank's wealth doesn't change – because the loaned money, once repaid with

interest, has no more purchasing power than it did when it was loaned out. If interest rates are *lower* than inflation, then the REAL INTEREST RATE is *negative*: the borrower, not the lender, is better off at the end of the loan because the money they pay back is worth less than the money they borrowed. The higher is inflation, therefore, the lower is the real interest rate. That's why financial institutions hate inflation more than any other sector of society.

The costs of inflation – and its benefits, too

Governments, financiers, businesses, and even ordinary citizens often wring their hands over inflation. And under neoliberalism, the never-ending fight to reduce and control inflation has become the top economic priority: more important than reducing unemployment or alleviating poverty.

It is true that inflation can be painful. At very high levels, it can be downright destructive. But the social costs of inflation are often exaggerated by those (like bankers) who have vested interests in a low-inflation environment. And at moderate levels, inflation can actually be good for the economy – serving as a kind of lubricant to grease the economic wheels.

If every price and every flow of income experienced inflation at the same rate, it would have no real economic impact, and no winners or losers. This was true in the preceding example of an economy which converted from dollars to cents. The absolute price level grew by 100 times, with no real effect whatsoever.

In real life, however, inflation is never so even-handed or predictable. Some prices rise faster than others. Some incomes keep up with inflation, or even surpass it; others lag behind. Inflation (or more precisely, changes in the rate of inflation) creates uncertainty in the minds of companies, investors, and households; this can be stressful, and in some cases can impede investment.

Individuals or groups try to protect themselves against inflation by indexing their incomes to the price level. Labour contracts or social programs which provide for automatic cost-of-living adjustments are a common way to do this.

Some sectors of society, meanwhile, actually benefit from inflation (and from an increase in inflation). Borrowers are the biggest winners: the real burden of their loan is eaten away by higher prices. Governments are large debtors, so in theory they should

Measuring Inflation

The most common measure of prices is the **CONSUMER PRICE INDEX (CPI)**. This is a weighted index of inflation in all the things that consumers buy, including shelter, food, transportation, personal services, and household products and appliances. Statisticians gather detailed information (usually each month) on the prices of all products included in a specified "basket" of typical consumer purchases. Each product is then weighted according to its importance in overall consumer spending. The index is phrased in terms of prices in a certain base year (when the CPI is set to 100). Annual inflation in consumer prices then equals the percentage rise in the CPI index over one year. Since the CPI is based on the most detailed and frequent statistical research, and is widely reported in the media, it receives the most attention from policy-makers (including central banks).

There are other measures of inflation, too. Special price indices are calculated to measure average inflation in producer prices (like raw materials, parts, and other supplies), or commodities (such as oil, other forms of energy, minerals, and bulk foods). Somewhat different is the **GDP DEFLATOR**: this measures inflation as the difference between the increase in nominal GDP and the increase in real GDP (both of which are separately estimated by statistical agencies). Deflators can also be calculated for any particular component of spending in GDP (such as consumer spending, investment, and exports and imports).

be relatively unconcerned about inflation. This makes it especially ironic that neoliberal governments pushed so hard for strict anti-inflation remedies in the 1980s and 1990s. A major side-effect of those measures (lower inflation and higher real interest rates) was a dramatic escalation in government debt.

On the other hand, some sectors lose from inflation:

- Individuals who live on incomes that are fixed in dollar terms lose purchasing power when overall prices rise.
- Workers who are unable to win wage increases to keep up with inflation also lose real purchasing power.

- Lenders who loan money at a fixed rate of interest will see the real value of their loan (and future interest payments) reduced by inflation. It is possible to index loans to inflation, but this is rare.
- Owners of financial wealth lose some of their real wealth with every increase in prices.

These latter two sectors – financial institutions and wealth-owners – constitute an immensely powerful and influential bloc in favour of reducing and tightly controlling inflation. Their very negative experience during the 1970s, when accelerating inflation produced negative real interest rates and destroyed trillions of dollars of private wealth, led them to forcefully demand (and win) strict anti-inflation policies under neoliberalism.

In terms of the impact of inflation on overall economic performance (as opposed to its varying distributive impacts on different sectors of society), there's no conclusive evidence that moderate inflation undermines real investment, growth, or productivity. Higher rates of inflation can indeed cause significant economic and social stress, as individuals and companies take drastic measures (including the removal of capital from the country) to protect their incomes and wealth. And very high inflation (called HYPER-INFLATION) is usually associated with economic and political breakdown.

But there's no reliable evidence that single-digit inflation (under 10 percent per year) harms real economic progress. If anything, there seems to be a positive connection between single-digit inflation and growth: not because inflation *causes* higher growth, but simply because faster-growing economies tend to experience somewhat faster inflation. Some economic evidence suggests that modest inflation (in the range of 2–4 percent) is actually beneficial. It allows sellers of various commodities (including workers, who sell their labour) to reduce relative prices when necessary, without actually cutting nominal prices (in dollars). Modest inflation thus lubricates the ongoing relative price adjustments that are necessary in any evolving economy.

Beyond this low rate, however, there's no convincing evidence that there are any economic benefits to inflation, either. In particular, there's no predictable relationship between unemployment and inflation. Economists once believed that an economy could "trade" a slightly higher rate of inflation for a slightly lower rate of unemployment, but

empirical evidence has refuted this theory, as well. In fact, there's no reliable relationship at all between inflation and unemployment.

The causes of inflation

Inflation is a complex, unpredictable phenomenon. Over the years, many economists have developed one-size-fits-all theories of inflation, its causes, and its remedies. But these simplistic theories have failed.

For example, the ultra-conservative monetarists who became so influential with the advent of neoliberalism (led by Milton Friedman) believed inflation was caused solely by an excess supply of money. This was proven wrong in the 1980s. Others argued inflation would take off whenever unemployment fell below its so-called "natural" rate. This was proven wrong in the 1990s. Today's central bankers have a more nuanced but still one-dimensional view: inflation results when overall spending exceeds the economy's vaguely-defined "potential output." Restraining spending (through higher interest rates, when needed) is the latest one-size-fits-all prescription for controlling inflation. Eventually this theory will be proven wrong, too.

In reality, there are many potential causes of inflation. Policy-makers should take a pragmatic, flexible, and balanced view of these various causes – because the appropriate cure for inflation (when one is deemed necessary) depends on its cause:

- Inflation can indeed result from excess spending; this is called "demand-pull inflation." If consumers and businesses are increasing spending too aggressively (fuelled, probably, by a rapid expansion of credit) relative to the quantity of goods and services available to purchase, then prices may be bid up as purchasers compete for scarce supplies. Curing this kind of inflation could involve reducing demand (through *higher* interest rates). But it could also involve stimulating additional supply (including measures to encourage investment – which would require *lower* interest rates).
- Inflation can result from higher labour costs. If wages grow faster than productivity, then unit labour costs (the ratio of labour costs to productivity) will increase. Companies will try to pass on those higher production costs in higher prices. Depending

on competitive conditions, they may or may not be able to do this. Potential responses to this kind of inflation include deliberately promoting unemployment (as neoliberal central banks have done), finding ways to moderate wage increases when unemployment is low (perhaps through economy-wide bargaining arrangements, as exist in some European countries), or trying to prevent companies from passing on higher prices (through price controls, more competition, or increased imports).

- Higher profits can cause inflation, too – not just higher wages. If companies feel that they can increase prices without losing customers (perhaps due to a lack of competition, or a willingness of customers to tolerate higher prices), they will do so.
- Another kind of inflation arises from increases in raw material prices, especially for crucial commodities used as inputs throughout the whole economy. Energy costs are an important example of this problem: higher oil prices were a major cause of the inflation of the 1970s. This type of inflation usually arises from global changes in commodity prices, which makes it hard for individual countries to control.
- Inflation can become self-fuelling: once it starts, then the actions of various economic players to protect themselves (such as companies passing on higher prices, or workers demanding cost-of-living adjustments) reinforce inflation at that rate. For this reason, inflation rates tend to demonstrate a natural *inertia*: inflation next year will likely be similar to what it was this year, unless some significant change in economic conditions "knocks" the inflation rate off its mooring.

Real-world experience has indicated two additional insights regarding changes in the inflation rate:

- Reducing the inflation rate is a very painful process, usually involving recession, high unemployment, and lost economic opportunity. On one hand, this suggests extreme caution in deciding to reduce the inflation rate: the costs of doing so are very high, and the benefits (when inflation is moderate, anyway) are questionable. On the other hand, it also suggests caution in

allowing inflation to increase – because the cost of bringing it back down, if that is ever deemed necessary, will be painful.

- Increases in employment and purchasing power can be associated with higher inflation, for obvious reasons. When more people are working, earning more money to spend, they willingly pay more for the things they buy, and companies willingly pump up prices. Experience has shown, however, that if economic expansion is gradual and steady, then the inflationary impacts of growth and employment are muted. Companies have time to respond to strong purchasing power with more output, rather than higher prices, and competition will be more effective in restraining prices. Sudden surges in growth or employment, on the other hand, are more likely to lead to outbursts of inflation.

Central banks

CENTRAL BANKS are probably the most important single actors on the economic stage. They have an immense impact on the economy – more than governments. They have the power to closely regulate everything from prices to job creation to incomes. And in most countries, central banks perform their duties without any direct accountability whatsoever to the broader population, or even to government … even though the central bank itself is a government agency!

The first central banks (like the Bank of England) were created in Europe in the early days of capitalism, to provide banking and credit services for national governments. In the twentieth century their role evolved, partly in response to problems encountered in the private banking system. Central banks took on additional tasks: supervising private bank lending, imposing limits on especially risky bank activities, and stepping in during times of crisis and panic to provide emergency loans and forestall bank collapse. Because of this role, the central bank is often called the "lender of last resort."

More recently, these supervisory functions have become less important as private finance has been mostly deregulated. But central banks must still be ready to act quickly in times of crisis. For example, in 1998 the US Federal Reserve bailed out several large private financial firms (including Long Term Capital Management, a notorious investment fund) to prevent an all-out financial panic

when their speculative investments suddenly collapsed. It did the same thing again a decade later (joined by other leading central banks) in response to severe problems in the US mortgage lending industry.

More important today than regulating private banks, however, is central banks' role in regulating the "temperature" of the whole economy. Central banks are in charge of MONETARY POLICY: using interest rates (and, occasionally, other policy instruments) to either stimulate or discourage growth and job creation. Low interest rates stimulate credit creation and spending across many sectors of the economy: including home-building and construction, cars and other major consumer purchases, business investment, and even exports (low interest rates tend to reduce a country's exchange rate and thus stimulate more foreign sales). High interest rates have the opposite effect.

Central banks directly control interest rates on short-term loans they provide to private banks, as part of the normal day-to-day clearing and accounting operations that occur in the financial system. In turn, private banks use this interest rate as a guide in setting the rates they charge customers for everything from home mortgages to business lines of credit. (Of course, the banks add a generous profit margin for themselves.) In turn, longer-term interest rates (like long-term bond rates) tend to follow the (longer-term) direction set by central banks. Central bank policy, therefore, is the crucial determinant of interest rates across the financial spectrum.

The impact of interest rates on economic growth is relatively slow to be felt: a change in interest rates can take up to two years to have full effect on spending. And monetary policy can be undermined or even overwhelmed by other factors – such as changes in consumer or investor sentiment, exchange rates, or government taxes and spending. Unfortunately, interest rates are also a very blunt instrument: they're a one-size-fits-all policy tool, which can't take account of unique conditions or problems faced in specific regions or specific industries.

Nevertheless, interest rates are a powerful tool with which the central bank influences the overall path of the economy. And the criteria on which central banks make their decisions are not "neutral" or "technical." They reflect central bankers' views of the economy, their ranking of the importance of different economic goals (holding inflation as more important than unemployment, poverty, and other economic problems), and their susceptibility to the influence of different sectors within society. Central bankers like to pretend

they are neutral technocrats, merely helping to guide the economy to some mythical point of maximum efficiency. But in reality they are political institutions – and like other political institutions, their actions reflect judgements regarding which priorities are more important than others.

Neoliberal monetary policy

During the long Golden Age expansion, central banks generally supported efforts to keep the economy as close to full employment as possible. However, both the direction of monetary policy and the ways in which it is implemented changed dramatically with the advent of neoliberalism. Indeed, the change in monetary policy that began in the late 1970s was the first and most important indicator of the dramatic U-turn being engineered at the economy's highest levels. And monetary policy remains one of the most powerful and entrenched features of the broader neoliberal agenda.

Blood on the Floor

"The Federal Reserve had to show that when faced with the painful choice between maintaining a tight monetary policy to fight inflation and easing monetary policy to combat recession, it would choose to fight inflation. In other words, to establish its credibility, the Federal Reserve had to demonstrate its willingness to spill blood, lots of blood, other people's blood."

Michael Mussa, former Research Director, International Monetary Fund (1979), cited in Andrew Glyn, *Capitalism Unleashed: Finance, Globalization, and Welfare* (Oxford: Oxford University Press, 2006), p. 24.

Initially, neoliberal monetary policy was heavily influenced by the monetarist ideas of Milton Friedman and other ultra-conservative economists. They weren't concerned with unemployment, arguing that it reflected laziness or the perverse impact of labour market "rigidities" (like unions, unemployment insurance, and minimum wages). In their extreme interpretation of neoclassical theory, the only impact of money is to determine the absolute price level. Therefore, to control inflation, central banks simply had to control the growth

of the money supply. If they allowed an annual 5 percent increase in the total supply of money, and if they stuck to that rule for a long time, then inflation would eventually settle at 5 percent. Thus began an experiment in MONETARY TARGETING (trying to directly control the expansion of money) that was a colossal failure.

The vicious global recession of 1981–82 was caused directly by monetarist policies. Their effort to link inflation to money supply growth failed, because in a credit banking system central banks *cannot* control money supply. Rather, money expansion is determined by the credit-creation activity of private banks and the willingness of borrowers to take on new loans.

However, that deliberate recession was ultimately successful in signalling the beginning of a new era in global capitalism. It disposed of the notion that full employment was the top economic priority. And it began the long, painful process of ratcheting down popular expectations, regarding what average people can (and can't) expect from the economy.

Since then, central banks have fine-tuned their approach to controlling inflation. Like the original monetarists, modern central bankers still believe the free-market economy is largely efficient and self-adjusting (see Table 17.1). The only long-run impact of monetary policy, they still believe, is on the rate of inflation; free-market forces in the real economy determine real output, employment and productivity. Central banks should therefore have tunnel vision: focusing only on controlling inflation, ignoring other goals (like job creation). *

However, modern central banks have altered their operational strategy for pursuing this common vision. They no longer try to control the money supply directly, recognizing that money expansion depends on the creation of credit. Instead, most central banks now directly target a certain inflation rate. To attain the targeted inflation rate, central banks influence credit creation and hence spending by frequently adjusting interest rates. It is clear that the fundamental assumptions of the monetarists have been inherited by today's central bankers, who can therefore be considered "quasi-monetarists." (Neoclassical economists arrogantly call this approach the "New Consensus" in monetary policy – ignoring the criticisms made by heterodox thinkers.) They still believe that controlling inflation is the

* See the Economics for Everyone website for statistics, www.economicsforeveryone.com.

Table 17.1 **Monetarism and "Quasi-Monetarism"**

Areas of Agreement:	
Monetary policy should focus solely on controlling inflation, not reducing unemployment.	
Apparent unemployment is either voluntary (people who don't want to work) or due to labour market frictions and rigidities.	
The only long-term way to reduce unemployment is to eliminate labour market frictions and rigidities.	
Near-zero inflation will assist the real economy to reach its natural full-employment equilibrium.	
The central bank should be independent and "apolitical," free from political interference or democratic oversight, to insulate its inflation-controlling mandate from popular pressure.	
Monetarism (Milton Friedman, 1980s)	***Quasi-Monetarism (modern central banks)***
Areas of Disagreement:	
Inflation is caused by too much money.	Inflation is caused by too much spending.
Central banks should directly control money supply.	Central banks should indirectly manage money supply via the interest rate.
Central banks should target growth in the money supply, to control inflation indirectly.	Central banks should target the inflation rate.
Economic fine-tuning doesn't work; government should stand back and let markets re-create full employment.	Constant fine-tuning of interest rates guides the economy to its full-employment equilibrium.

central, even exclusive goal of central banking; all they have changed is their view on how that goal should be pursued.

Another important feature of neoliberal monetary policy has been an emphasis on entrenching the so-called "independence" of central banks. In most developed countries, central banks have been granted day-to-day freedom to pursue their goals without oversight or interference from government. To varying degrees, national governments still participate in determining the banks' broader objectives – most importantly, setting formal inflation targets (where they exist). But they are prohibited from influencing the banks' regular interest rate adjustments or other actions.

The deliberate goal of this structured independence is to insulate the powerful, often painful interventions of central banks from popular pressure. Of course, central banks are not really "independent" at all:

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the elevation of inflation control to the top of the economic agenda, regardless of what else is sacrificed in the process, is a non-neutral and highly political choice that imposes uneven costs and benefits on different segments of society. The financial industry and owners of financial wealth have benefited most clearly from neoliberal monetary policy. And they continue to have huge influence over the day-to-day actions of central banks. But by erecting central banks as an independent, supposedly apolitical authority, elected governments pretend that choices regarding the fight against inflation are out of their hands.

Central bank "independence" is explicitly and deliberately anti-democratic. It removes a crucial element of public economic policy from the realm of public deliberation and control. By pretending that monetary policy is a neutral, technical, and hence apolitical activity, governments hope that public debate over monetary policy will evaporate.

Evaluating quasi-monetarism

Neoliberal monetary policy has been highly successful in several of its stated goals. Global inflation rates have subsided notably since the early 1980s (see Figure 17.1). In recent years, inflation throughout most of the developed capitalist world (and many developing countries, too) has been remarkably stable at around 3 percent – despite relatively low unemployment rates, and the sharp energy price increases which occurred early in the new century.

In broader political terms, too, the new agenda has been highly effective. In most countries, there is very little public debate about interest rate policy. The notion that interest rates should be used to control inflation, and nothing else, has gained wide currency, even among centre-left political leaders (whose acceptance of this strict regime is usually motivated by a desire to impress powerful financial lobbyists with their "realistic" economic views). And the former belief that the economy can and should be managed in order to maintain full employment seems dead and buried.

Dig deeper, however, and the completeness of this triumph is not quite so clear. While broad consumer price inflation has declined, this is not solely due to monetary policy. Other factors – like shrinking unit labour costs, the rise of low-cost imports from China, and other time-limited effects – also played a role. Moreover, periodic bouts

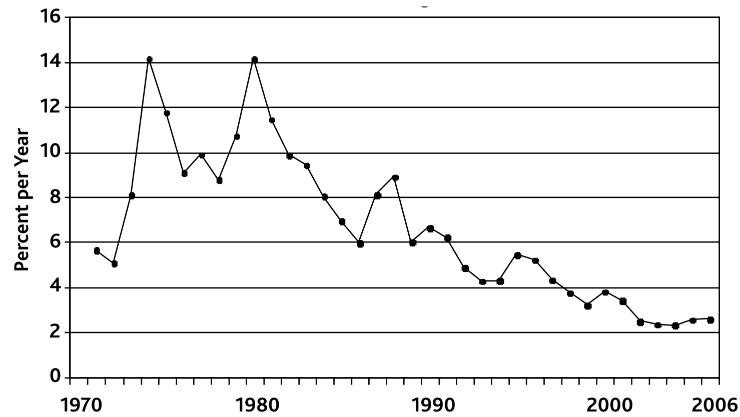

Figure 17.1 **Consumer Price Inflation OECD Average**

Source: Organization for Economic Cooperation and Development.

of inflation in asset prices (including unsustainable bubbles in stock markets and real estate) have been a regular and at times disastrous feature of life under the quasi-monetarists, proving that they haven't truly achieved "price stability."

More fundamentally, the promised boost to real investment, growth, and productivity which was supposed to accompany low inflation has been very hard to detect. GDP growth rates are consistently slower than they were even in the latter, troubled years of the Golden Age expansion, and real business investment has slowed noticeably. This failure to stimulate stronger improvements in the real economy is the most important crack in the apparent triumph of quasi-monetarism.