The Gower Initiative for Modern Money Studies

Inflation

The rate of inflation, the growth of GDP and the unemployment rate are the three indicators of how an economy is performing which are most widely discussed (sustainable models of the economy use, and are developing, alternatives to GDP). So it might be expected that these measures are easy to explain and are governed by straightforward rules. This is not the case. Finding a way to describe inflation in our fact sheet which would be both comprehensible and not misleading has been a challenge.

What is inflation?

The inflation rate is a measure of how quickly the cost of living for a typical household is increasing across a year. If prices keep rising by the same amount, say 2% every year, then that would be considered a stable inflation rate. If they rise faster as time goes by, that is accelerating inflation and if prices rise more slowly that is falling or decelerating inflation. If most prices are falling, that is negative inflation or, if sustained, deflation. If circumstances create an inflation rate of more than 50% then that is considered to be hyper-inflation. Both deflation and hyperinflation have destabilising effects on the economy.

In the UK, inflation is measured by a ‘shopping basket’ monitored by the Office of National Statistics (see https://www.gov.uk/government/statistics/announcements/consumer-price-inflation-basket-of-goods-and-services-2018) and reviewed annually to ensure it reflects the typical shopping habits of the country. For many years the standard measure was the Retail Price Index (RPI) and this is still published, although it has limited use as it no longer conforms to the standard required. RPI has been replaced by the Consumer Prices Index (CPI), which was first published in 1997 and produced to international standards in line with European regulations. This is the measure used for the government’s target for inflation, which it aims to keep low and stable. There is a more comprehensive measure, known as CPIH, which extends CPI to cover owner-occupiers’ housing costs and Council Tax.

Not only is there a great deal of debate over the measurement of inflation and what level is ‘good’ or ‘bad’ for the economy (inflation is loaded with moral value judgements), but the process of calculation is very complex. Prices are weighted, only certain goods and services are included and these have to be both seasonally adjusted and adjusted for changes in consumer spending patterns over time.

GDP, Inflation and Unemployment

Despite the rather dry descriptions above, maintaining a stable inflation rate is considered by many to be one of the two greatest problems facing the economy. The other is minimising the unemployment rate. Conventional explanations of the relationship between GDP, employment and inflation hold that increasing the rate at which GDP grows brings about a corresponding drop in unemployment. But this effect doesn’t continue all the way up to full employment because inflation becomes a problem before full employment is achieved (unless there is a well-designed job guarantee to stabilise levels of wages and consumption).

Definitions of full employment differ between mainstream economics and MMT. Mainstream economists consider that, as the economy approaches full employment, the rate of demand from consumers will tend to outstrip the economy's ability to produce more goods and services. Furthermore, the shortage of labour to fill vacancies creates a competitive market for employees, which means they will be able to get bigger pay rises. These two issues are liable to raise the inflation rate. It can be seen from the mainstream perspective that the 'optimum' level of employment is the point immediately before inflation starts to rise. This is called NAIRU, or the Non-Accelerating Inflation Rate of Unemployment.

In MMT, full employment is the point at which everyone who wants a job has a job (and there is no undesired underemployment). You can read more about the MMT response to NAIRU at https://gimms.org.uk/job-guarantee/. Work by MMT researchers shows that the government is the monopoly issuer of the currency and sets the price for goods and services including the price of labour. MMT replaces unemployment, as per mainstream economics, with an offer of useful employment at an equitable social wage in a job guarantee as a means of controlling inflation.

The Job Guarantee fixes a floor price of labour, by offering a living hourly rate job in the public sector. The private sector cannot employ all workers, (especially in an economic downturn) but the government can. In MMT, there is a Non-Accelerating Inflation Buffer Employment Ratio (NAIBER), which measures the proportion of the total workforce in the job guarantee when the inflation rate is stable. When every worker available to work has a job, the economy is at full employment.

The Job Guarantee is a critical mechanism for maintaining the total demand for goods and services in the economy. It allows the government to ensure the population can always find a job, and that employers deliver wages and conditions equal to or better than the Job Guarantee rate. This evens out the peaks and troughs of the business cycle, by ensuring that the real economy has a supply of employed workers with enough income to maintain demand for goods and services who are poised to transition to the private sector as it expands.

Importantly, as an additional benefit, the Job Guarantee reduces the costs to society of mass unemployment. The social, economic and personal costs of mass unemployment are enormous. Long term unemployment impacts mental health, family breakdown and crime; these effects are inter-generational. Resolving these problems requires many resources.

The role of the central bank

The government's 'target' inflation rate is, at the moment, a guide to central banking policy on interest rates. Conventional thinking on inflation considers 'inflation expectations', or predictions of the level of inflation to be highly significant. Levels of 1-2% per year are considered to be acceptable or even desirable, whilst rates which rise above 3% are a concern. Levels of 1-2% indicate price stability, which is the goal of inflation control. It means that individuals and business can predict their spending with reasonable certainty. But if it falls too low then the economy is considered to be struggling to maintain its growth. If the central bank is not meeting its target for inflation it uses interest rates to affect the rate of private lending, borrowing and spending, although this rarely has the desired effect, as there is no direct and reliable link from interest rates to spending.

One of the potential problems with prices either falling or not rising at the expected rate is that consumers might decide to delay their spending to see if prices fall further and they can pick up a bargain. Putting off spending in this way decreases the total demand in the economy, reduces growth, and slows the attainment of the target inflation rate even further. Another problem is that falling prices often also mean falling wages, making it hard for people to pay off their debts.

On the other hand, rapid inflation might make consumers panic-buy. This potentially creates a greater increase in the total demand in the economy which can push the inflation rate even higher.

What causes inflation?

The simplest answer to this question is that too much of *any* kind of spending *can* create inflation, whether this comes from the government, *or* from the non-government sector (through spending out of current income, from past savings, via bank credit or from foreign direct investment). A little steady inflation is seen as 'good' and too much or little is seen as 'bad'. When either the government or non-government sectors of the economy spend ('non-government' comprises individuals, businesses and the rest of the world that trades with us) it can cause inflation - but doesn't necessarily. This can be illustrated by a brief look at the UK economy in the 20th century.

The 'post-war consensus'

In the aftermath of World War II, up until the 1970s, the dominant economic theory in the UK held that there was a stable inverse relationship between inflation and unemployment. In this scenario, some inflation is the acceptable cost of economic growth because firms will hire more employees to fulfil the growing demand for their goods. The inverse of this rule is that if the economy slows then unemployment will rise, but inflation will fall. The response to a slowing economy would be for the government to spend more on public services to create greater demand.

Price shocks in the 1970s – the effect of producers restricting supply

In 1973 the Organisation of Arab Petroleum Exporting Countries embargoed oil exports to the nations which had supported Israel in the Yom Kippur war. This created a 'price shock' as supplies fell and prices rose significantly leading to both short and long term economic and political consequences. The effect was not only felt by car owners at petrol pumps, where prices rose steadily from 34p a gallon (4.54 litres) in 1971 to £1.28 a gallon in 1980, but also by the commercial and public transport industries. Every industry which uses petroleum by-products, from plastics to lubricants to cosmetics, was faced with rising costs as the impact of the embargo filtered through. Although barrels of crude oil are not in the 'basket' for calculating inflation, the increasing cost base of production had a very large impact.

This kind of inflation is not based upon an inverse relationship with unemployment, because it is not the result of demand rising too high, but of costs rising. Inflation rose and so did unemployment. Trade unions fought to keep their members' wages in line with the price rises (when inflation is greater than wage rises workers have less spending power - an effective pay cut). The government increased its spending in an attempt to boost the economy. Government spending as a percentage of GDP rose from 42.7% in 1970-71 to 49.7% by 1975-76. But this was not enough, it did not make the economy grow.

A paradigm shift – an association is created between inflation and government deficit spending

By 1976, neoliberal politicians and economists had taken advantage of the oil crisis and misdiagnosed the causes of higher inflation to change the direction of economic policy (see fact sheet The Origins of MMT at https://gimms.org.uk/fact-sheets/origins-of-mmt/). The Treasury's misguided response to the economic pressures (in particular the fall in the value of the pound which was seen a major source of inflationary pressure) was to make an application for a foreign currency loan from the International Monetary Fund (IMF), in order to support the value of the pound. This was granted in exchange for commitments to cut public funding by £2.5 billion. The cuts were made although the loan was only partly drawn down.

At the 1976 Labour Party Conference Prime Minister Jim Callaghan said, *"We used to think you could spend your way out of recession and increase employment by boosting government spending. I tell you, in all candour, that that option no longer exists. And in so far as it ever did exist, it only worked on each occasion… by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step…"*

This was a simple idea extracted from a misunderstanding of the events of the 1970s, and promoted by neoliberal propagandists, including the monetarist Milton Friedman. Government spending, rather than the oil crisis, was held responsible for the economic problems. When the Thatcher government won the election in 1979, it based inflation control on high interest rates and took steps to make the country what she and her government saw as more competitive. Inflation was very high at 22% in 1980 but was reduced by 1982 to around 10%, following the collapse in the price of oil and a serious recession. Publicly owned industries were sold off to 'pay down the national debt' and public services were stripped back to reduce the deficit. Public spending as a percentage of GDP fell to 38.9 by 1988-89 , and the price was paid in unemployment.

The Conservative election slogan in 1979 was 'Labour isn't working' as there was a high unemployed figure of 1.5 million. But as inflation reduced, unemployment doubled to 3 million – 12.5% of the workforce - by January 1982. The regional impact was stark, with Northern Ireland topping 20% and much of the North, including Scotland, over 15%. It took until the end of the decade for the figures to drop to 1979 levels. Even then, underemployment and insecure employment with fewer employment rights were the price people paid, in a far less equal society.

MMT and Inflation

One of the most frequent and ill-informed criticisms aimed at MMT is that it does not pay sufficient attention to the problem of inflation. MMT's basic principle, that monetary sovereign government spending is not limited by borrowing, debts or deficits ('balancing the books') but rather by the real resources available to purchase in the economy, is characterised in these criticisms as a recipe for 'unlimited money printing'. This 'money-printing', say the critics, will leave the economy facing high or hyperinflation, referencing some past or current situation, particularly Zimbabwe or the Weimar Republic in Germany.

In each case of hyperinflation, the initial cause has been a sudden and massive collapse in the productive capacity of the economy, and in what is available to buy, and also strong evidence of massive corruption in the banking systems and state owned enterprises by insiders that resulted in large and continuous sales of the currency in exchange for foreign currency for personal holdings. When there are fewer goods and services available to buy, the increasing government spending required to pay rising prices just makes those prices accelerate upwards. However, modern Britain has nothing in common with a post-WW1 Germany, or a post-2000 Zimbabwe.

The MMT view is that Government is the monopoly issuer of the currency and as such sets the price of goods and labour when it spends. That is, whether it knows it or not, Government is setting the value of its currency by the prices it pays, and under current policy, the availability of real resources limits the potential for inflation. In any case, an imbalance between spending and production will always be a binding constraint on government fiscal policy, even if they have a sovereign currency with no financial limits on their capacity to spend. If spending exceeds productive capacity, that is the time to cut spending, raise taxes and use other measures, including tightening the availability of credit, to reduce inflationary pressures.

The differences with mainstream economics are that it is the state of the economy which sets the appropriate size of the government's budget, rather than a mistaken belief in the need for the government to 'balance its books', as though it was a household or a business; and that any jobs lost in the private sector due to a need to slow down the economy would be replaced by job guarantee jobs, rather than forced unemployment. But MMT is not a prescription for unlimited spending – governments have to think very carefully about when caution is required because there is a real inflationary risk determined by the availability of real spare capacity. It recognises that the problems and costs of mass unemployment are much greater than small changes to the rate of inflation.

Economic policy matters. The steps governments take to increase or restrict public services, privatisation, tax cuts for the super-rich, tax incentives for industry, all these individual actions are driven by the government's belief in the efficiency and effectiveness of those policies to achieve those three top goals: growth, stable inflation and controlling unemployment. And voters need to have an understanding of what these things mean in comprehensible terms, otherwise framing the target for government as being primarily on 'balancing the books', 'running a surplus' or 'reducing interest rates to control inflation' will mask any of the real questions.

The job is not to 'balance the budget'.

It is to balance the economy.

More information:

Professor L. Randall Wray on how to fight inflation - https://youtu.be/6jW0LocWYZ8

Professor Bill Mitchell discussing the MMT take on hyperinflation - https://youtu.be/yWGJ_js8huA

Professor Bill Mitchell discussing the biggest cause of hyperinflation in Zimbabwe - https://youtu.be/K_NKxRyUyJQ

Discussion with Professor Bill Mitchell and Warren Mosler on the societal costs associated with unemployment and inflation - https://youtu.be/6kILjC3P9z4

Professor Stephanie Kelton explains Modern Money and inflation - https://youtu.be/mTFjfNoSUGI

Warren Mosler on inflation (from 24 minutes) - https://youtu.be/jfJAdxnGNL8?t=1440

Professor Pavlina Tcherneva: Monopoly Money: The State as a Price Setter, Oeconomicus, Volume 5, Winter 2002, pages 124-143