Inflation Is Always And Everywhere A Political Phenomenon

Frances Coppola

Milton Friedman’s famous aphorism….

“Inflation is always and everywhere a monetary phenomenon”

…..ignores the political economy of inflation

Conventional view

- Creation of money is monetary policy,
  Distribution of money is fiscal policy

- Monetary policy is the responsibility of central banks
  Distribution of money is the responsibility of fiscal authorities

- Inflation will be uncontrollable if governments are responsible for money creation
  ⇨ independent central banks

- Inflation will be uncontrollable if governments control the distribution of money
  ⇨ fiscal rules, "balanced budget" requirements, debt brakes
  independent fiscal councils
  "quasi-fiscal" central bank (ECB)

To keep inflation low and stable, decisions about creation and distribution of money must be insulated from politics

Reality

Monetary policy has fiscal effects
Fiscal policy has monetary effects
Both are influenced by politics
Both have political consequences

Distinction between monetary and fiscal policy is artificial
Central banks and fiscal councils are political actors

How money is created

- Most money circulating in the economy is created by commercial banks in response to private sector demand for loans
- Most bank loans are for the purchase of assets, particularly property
- Younger and poorer people are more likely to borrow than older and richer people
- The rate of money creation therefore depends on the propensity of younger and poorer people to borrow
- Central banks influence the appetite of these people to borrow by adjusting interest rates

How fiscal decisions influence money creation by banks

- The distribution of money in the economy is primarily determined by tax & spending policies
- Policies that squeeze the incomes of younger and poorer people make them less likely to borrow
- Policies that increase the incomes of the rich do not make them more likely to borrow

Fiscal consolidation targeted at younger and poorer people decreases bank money creation

Fiscal expansion targeted at older and richer people does not increase bank money creation

Central banks can offset these effects with monetary policy

How fiscal policies affect aggregate demand

Policies that squeeze the incomes of younger and poorer people make them less likely to spend or may force them to cut back discretionary spending

Policies that increase the incomes of the rich do not make them more likely to spend

Fiscal consolidation targeted at younger & poorer people depresses inflation

Fiscal expansion targeted at older and richer people does not raise inflation

Conventional central bank monetary policy cannot significantly offset this

Inflation theories: questionable rationality

Inflation expectations: why would it be rational for people to believe the central bank will meet its targets if it hasn't done so for a decade? Why would raising the target change their expectations?

Phillips curve: is it rational to believe that in open economies with flexible labour forces, low unemployment must mean high inflation?

Interest rates: if most bank loans are being used for asset purchase, is it rational to expect that adjusting the cost of borrowing would significantly affect consumer price inflation?

Fiscal dominance: why is it rational to think that there is fiscal dominance if the central bank is monetizing government spending *ex post,* but not if the central bank is offsetting fiscal consolidation *ex post?*

FTPL: how rational is it to expect democratically-elected governments to commit to future primary surpluses far beyond the electoral cycle?

Credibility: if government can't be trusted not to cause runaway inflation, why is it rational to believe the central bank can control inflation?

Inflation control is all about credibility.....