Profits and pay are not to blame for inflation

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‘What really drives inflation? Profits or wages?” the European Central Bank tweeted in March. Most replies correctly offered variants of: “Neither. It’s monetary authorities like you.”

Prominent figures have seemingly forgotten this 1970s lesson. Paul Donovan, UBS chief economist, and left-wing politicians worldwide blame companies for “profit-led” inflation. Huw Pill, the Bank of England’s chief economist, points at workers’ wage demands as another source, concluding that “someone needs to accept that they’re worse off and stop . . . bidding up prices”.

Are we really doing this again? Economists have long accepted Milton Friedman’s dictum that “inflation [as a rise in the general price level] is always and everywhere a monetary phenomenon” resulting only from “a more rapid increase in the quantity of money than in output”.

Supply-shocks like the pandemic and Ukraine war reduced that output capacity. Yet whether you think it desirable for central banks to have tightened policy to offset price pressures from this, it’s obvious that the 25 per cent increase in the UK’s broad money supply since early 2020 contributed greatly to inflation too.

Arguments that corporations and workers are to blame make little sense. Surely no one believes corporations suddenly became “greedy” during late 2021, having not been since 2012. Donovan and the ECB’s far-fetched claim that businesses,

countries, have simultaneously exploited confusion about supply shocks to fabricate narratives of rising costs to justify raising mark-ups is equally implausible.

In competitive sectors, jacking up prices unilaterally would simply haemorrhage market share to lower-cost rivals. Even with market power, raising prices leaves customers with less left over to spend, reducing demand and price pressures for other goods. Corporate greed primarily affects relative goods’ prices, not the overall price level and inflation. Loose money driving excess spending does that.

Similarly, wage-price spirals generally do not “cause” inflation. If a workforce demands a competition-busting 20 per cent pay rise, and a firm acquiesces, raising its prices to compensate, it would either lose market share and lay off workers (pushing wages down elsewhere) or take more from customers (reducing price pressure for other goods). Any apparent wage-price

passthrough spiral we see is a slow-moving adjustment to a money-driven inflationary impulse, not its cause.

Such misunderstandings are forgivable for non-economists. For most of us, rising prices appear driven by cost increases. If consumers suddenly have more money, prices and profits at bottlenecks will surge first. As stickier prices and wages adjust more slowly, it can seem as if almost everyone is forced into raising their own prices because of rising costs elsewhere. But when this happens, the ultimate cause of these price rises is the original money printing that ends up with excess spending. Rising profits and wages are the effects.

Urging company and worker restraint to quell inflation is therefore like putting a heavy weight on one part of a waterbed mattress to lower its height. At best it just displaces inflationary pressure elsewhere; at worst it breaks things — muffling price signals and breeding inefficiency.

Asking people to forgo their economic self-interest to help reduce inflation is not just immoral, but futile.

The current inflation across the West, as with every other, is driven by supply bottlenecks and too much money pushing spending. To the extent bottlenecks caused it, price rises help provide incentives to ameliorate shortages. To the extent excess aggregate demand is the culprit, monetary authorities are culpable.

Central banks belatedly tightened monetary conditions, of course, and as temporary factors dissipate, inflation will fall. What railing against supposedly rapacious businesses and selfish workers does, though, is downplay the central bank errors that got us here. This risks the public misunderstanding inflation's causes and, in future, demanding damaging price and wage controls, rather than the appropriate monetary medicine.

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