"Inflation is always and everywhere a monetary phenomenon"

- Milton Friedman, 1963.

Discuss in the context of inflation the UK now faces.

Cambridge Society for Economic Pluralism Essay Competition

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In light of the Russia-Ukraine conflict, and the extent of its inflationary economic fallout, the explanatory power of monetarist rhetoric in understanding price levels is perhaps unjustifiable overshadowed. Indeed, reports of 'stagflation' in the face of unprecedented monetary and fiscal action highlight the diminishing responsiveness of the economy to orthodox measures, an aberration derived from increasingly archaic and unsustainable attitudes towards the relationship between monetary policy, growth and inflation.

Thus, as will be shown in this essay, despite the magnitude and abundance of exogenous influence, the monetarist inflationary thesis is not only relevant but central and necessary to understanding the genesis and persistence of current record inflation.

Fundamentally, there exists an empirical metric of the relevance of the Friedmanian quantity theory[21] in analysis of the subsequent model of exchange as can be considered:[1]

$$M \cdot V_T = P \cdot Q$$

M - The volume of money in circulation, V_T - The velocity of its circulation,
P - The general level of prices, Q - Indexed real expenditures on new goods[2] [16]

[1] We use the expenditure version of the original Fisherian form,[16] but Cambridge or transactional approaches can yield the same conclusions.

[2] i.e. 'output'

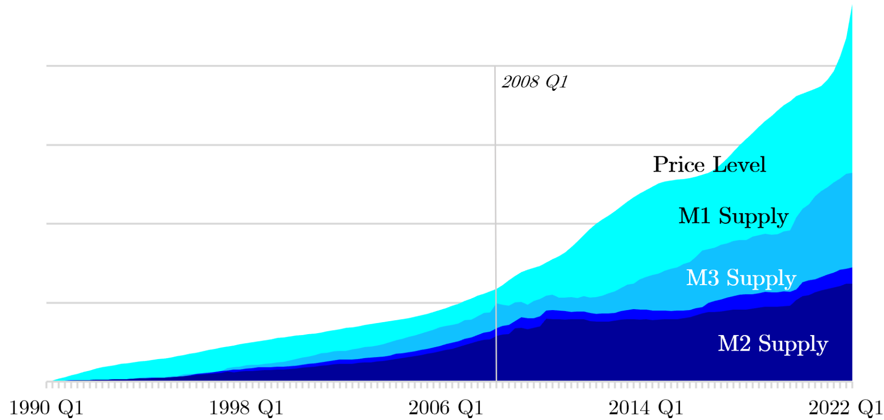

Figure 1: Empirical Scrutiny of the Quantity Theory
Source: Author's work[2][35][31][36]

Though the relationship depicted by the model is relatively intuitive and thus we might expect stability between price levels and money supply, as Figure 1 shows, post-2008 conditions undermine this hypothesis. Instead, we might make two critical long-term observations:[3]

1. Abundant monetary accommodation since the 2007-2008 financial crisis.
2. Increasing divergence between price levels and the money supply. That is to say, monetary accommodation is increasingly inflationary.

With regard to the former, fifteen years of virtually-zero bank rates,[6] alongside liberal quantitative easing (QE) initiatives have contributed to inflationary expansion of the money supply. While the immediate response following 2008 had less impact, subsequent monetary policy appears excessive given the rate of monetary expansion only increased.

Other COVID-related economic effects perhaps overshadowed the reality that Bank of England (BoE) QE enacted in response to the pandemic was greater than that of the 2007-2008 financial crisis.[4] This came alongside other monetary accommodation such as temporary loosening of UK bank liquidity reserve regulation, or the major fiscal stimulus initiatives intended to curb the risk of recession at the start of the pandemic[5] which, though successful in this aim, was again perhaps excessive considering the extent of simultaneous expansionary initiatives.

[3]The data also illustrates information useful in understanding more recent (e.g. COVID and Russia-Ukraine related) conditions, but this will be covered later in the essay.

Similar policy from other major central banks has reinforced this. In the US, the size of the Federal Reserve balance sheet more than doubled between March 2020 to July 2022, constituting an increase of 4.6 trillion US dollars,[8] with the European Central Bank and Bank of Japan, amongst others,[4] also contributing to an expansion of the international money supply which fuelled and exacerbated much recent inflation.[14][7]

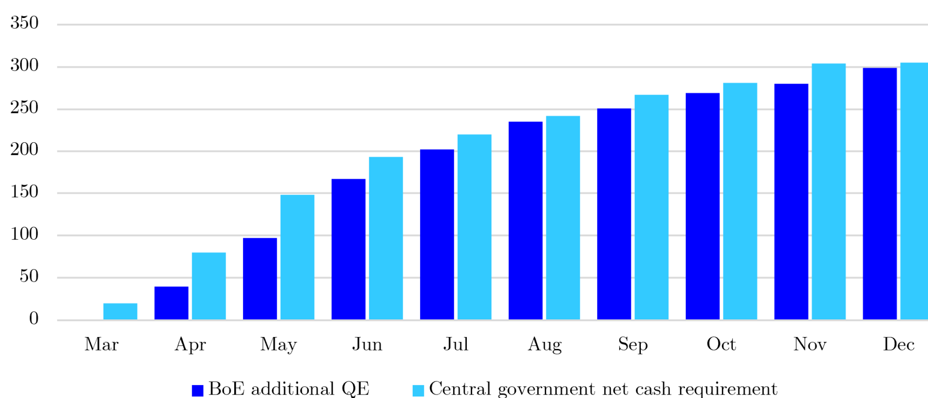

Figure 2: Comparing QE and Government Borrowing
Source: Author's work based on FT[15]

The direct impact of this aside, the metanarrative of central banks as unable or unwilling to effectively control inflation nurtures self-fulfilling expectations of future inflation as firms and households alike act to reduce the risk of loss to a future increase in the price level (Bordo 2014, Christelis et al. 2020).[9][12] Analyses such as Reis 2017[37] and Ward 2020,[45] alongside the uncanny tendency for QE to follow government borrowing needs[15] (see Figure 2) pave the way for speculation as to moral hazard, and improper incentives for future QE, as, for example, the sustenance of rising debt appears to be, again, contributing to inflationary expectations.

Forward-looking markets can therefore somewhat explain the second observation we initially made; the increasingly inflationary effect of expansionary monetary conditions is partially derived from the solidifying of central bank reputations as excessively accommodating and perhaps not as motivated by stable price levels as intended, or perhaps not as able to attain them.

[4] Deutsche Bundesbank, Bank of France, Central Bank of India etc.

However, both the increasing abundance and increasing inflationary impact of expansionary monetary conditions are derived from increasingly outdated and unsustainable attitudes as to their viability.

Traditional economic thought lauds expansionary monetary conditions as efficient in achieving growth, while addressing its inflationary demand impact as justified on the basis of longer-term improvements in output such that price levels, in the long run, price levels are stable.[24]

Modern economic growth, however, especially in developed nations such as the UK is increasingly driven by less capital-intensive industry[34] such as the digital sector, or services which contributed 72.8% of UK GDP in 2020.[38] This phenomenon is not abnormal, with many developed economies taking similar form for a multitude of reasons.[43]

Development-correlated stagnation is prominent due to external factors. Notably, diffusion in new technology and its mass production such as 3D-printing, AI, and digital communications has reduced the productive edge historically reserved for only the most sophisticated economies which, in combination with the strength of many Western currencies relative to those of many emerging economies has shifted competitive advantage further from its traditional Western focus than ever before.[42]

However, internal incentives are equally culpable. Non-productive initiatives as measured by economic output, constituting social initiatives and spending such as strong welfare systems, or greater labour market regulation or public services, or environmental production-reducing policies such as carbon taxes, regulation or 'green' investment have placed irrefutable burdens on the ability of many developed economies to pursue economic growth as rampant as their emerging counterparts.

This mixture of socio-economically desirable and largely insurmountable barriers to economic growth in many of its historic drivers contributes to an overarching ineffectiveness in expansionary monetary (and other) policy, yet attitudes towards their viability have remained the same. Indeed, in a climate of record political polarisation and unrest,[26] short-term unsustainable target-setting has become more relevant and in the interest of politicians and policymakers (Guriev et al. 2020), regardless of their long-term viability.

Given the archaic attitudes towards sustainable growth targets in many modern developed economies, and the empirical impact of expansionary monetary policy and conditions on price levels explored above, it is clear that policy affecting monetary conditions has been susceptible to such myopic policy-making, to great inflationary effect. Reduced returns (in terms of growth) from orthodox expansionary policy were met with more of the same despite the increased inflationary pressure this exerted.

Whilst this was true for at least the past decade, it was especially so for the monetary and fiscal response to COVID-19. Political turmoil and fears of recession fuelled excessively expansionary fiscal and monetary stimulus[5] which, though successful in their short-term objectives, perhaps rendered heightened inflation inevitable as the demand pent-up over pandemic lockdowns became backed by a rapidly expanding liquid money supply.

This said, current inflation can not only be attributed to the failure of sustainable monetary policy, but also the absence of effective alternative policies to combat inflation which is clear from the extent of UK inflation as above the OECD average.[30]

Perhaps the most relevant, effective and direct long-term policy for growth in the UK should revolve around supply-side investment and meaningful development, as is indicated by its poor productivity, as OECD data conveys its GDP/hour of 64.3 USD lags far behind that of comparatively developed economies such as Germany (74.3), France (77.6) or the United States (77.1).[29]

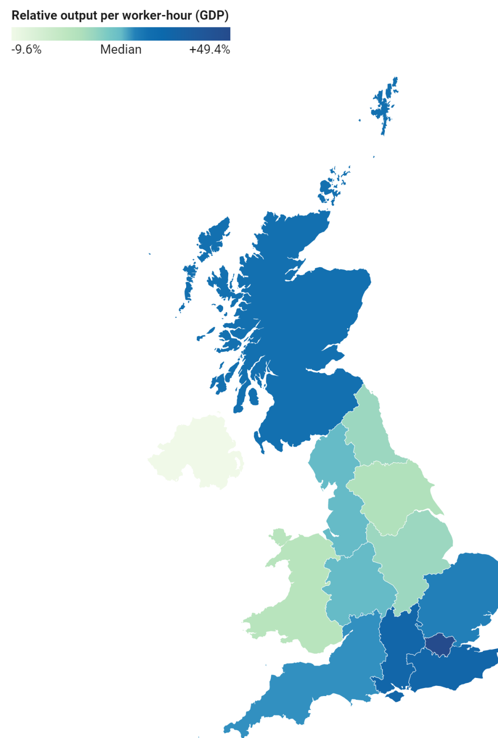

Figure 3: Disparity in Regional Labour Productivity
Source: Author's work[32]

Major regional fluctuation in productivity,[32] (see Figure 3) alongside poor geographical mobility and a history of fiscal policy concentrated around the capital has left much of the UK devoid of economic opportunity. This takes the form of selective access to education,[13] infrastructure,[28] and the absence of local opportunity for growth,[27] ultimately representing inefficiency as productive human capital across the UK is barred from reaching its full value-generating potential.

Aside from the direct impact on GDP due to stunted production, inequality deepens deficits, requiring substantial[22] spending on welfare and a range of socio-economic issues[25] and facilitating debts that cripple necessary responses to inflationary or other economic turmoil, while simultaneously contributing to the decline of the UK economy leaving its balance of payments to sink deeper into deficit and rendering it vulnerable to both exogenous shocks, and longer-term stagnation requiring more inflationary stimulus measures.

Notwithstanding the monetary or other longer-term policy shortcomings, underlying origin of current inflation undeniably lies in the commodity-turmoil associated with the Russia-Ukraine conflict.

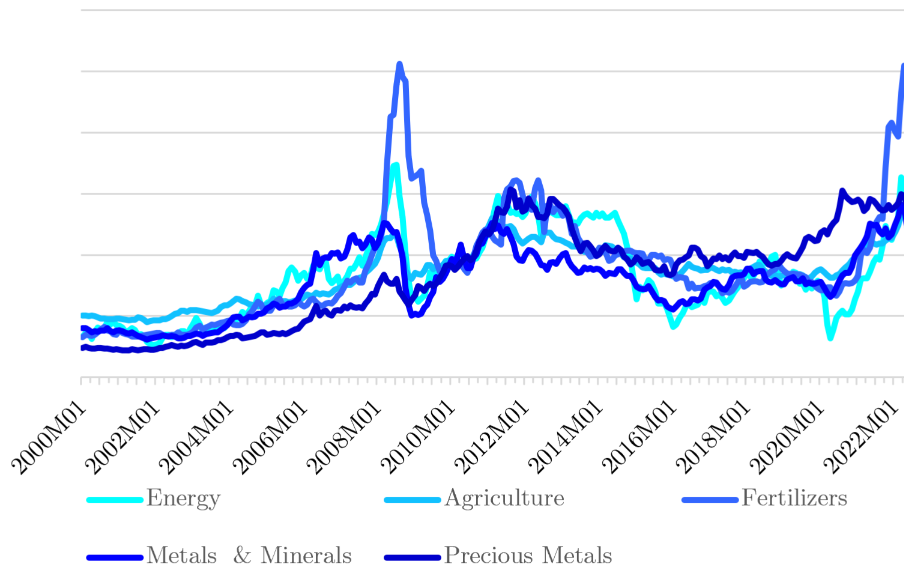

Figure 4: Recent Commodity Price Movement
Source: Author's work[41]

Figure 3 illustrates the commodity price fluctuation associated with recent inflation. Of course, the dependency of modern industry and society in general on fossil-fuels cannot be understated (e.g. Flamos 2013),[18] with approximately 80% of its energy having such an origin, and the reliance of its manufacturing industry (constituting 45% of UK exports)[39][5] on energy and mineral prices. Environmental initiatives have heightened this dependence, regulating or prohibiting the development of domestic fossil-fuel extraction or refining which might have reduced the impact of current turmoil, leaving the economy vulnerable to the current volatility and contributing to significant inflation.

In a global context, this supply-chain disruption comes consecutively alongside residual coronavirus obstruction (notably China's zero-covid persistence), and a longer-term increased competition for productive resources associated with advancements in technology requiring more complex supply chains, for example in the competition for African lithium supplies utilised in the electric-vehicle industry.[1] The result is thus a more significant increase in inflation than the Russia-Ukraine conflict might otherwise have constituted, especially in heavily net-importing nations such as the UK, unaided by the depreciation of the pound sterling over the past decade.[44]

Whilst inflation in agriculture and food markets has a reduced direct impact, its regressive nature[6] renders it perhaps the most intense and widespread source of inflation-derived hardship and poverty. While this itself is of ethical issue, it translates into greater political unrest which can hamper the implementation of anti-inflationary economic policy, and increase the incidence of aforementioned 'short-termism' and unsustainable strategies.

Due to the concentration of inflation across few commodities, the diffusion of inflation from affected to unaffected sectors has been rampant, and while the impact of the 'wage-price spiral' in driving up labour costs has no doubt had an effect, firms have to a greater extent been able to increase prices under the guise of inflation, and in response to increasing wages as unprecedented corporate profits suggest.[33]

The result ultimately appear driven by commodity turmoil given the Russian and Ukrainian roles in energy and food markets respectively, with a recent Deloitte report finding 51% of UK inflation arises from these.[23]

Thus, the results ultimately appear driven by commodity turbulence associated with the roles of Russia and Ukraine in energy and food markets respectively, with a Deloitte report finding 51% of UK inflation to derive from these.[23]

[5] And also much of its imports, with the economies of its largest (by value) trade partners also consisting of much manufacturing (Germany, China, Netherlands).[40]

[6] I.e. derived food prices representing a greater fraction of lower incomes.

Nonetheless, the magnitude of this inflation, alongside its persistence, reflects the underlying monetary conditions as was exhibited prior to the recent exogenous shocks as explored previously.

Thus, to conclude, the central Friedmanian inflationary thesis holds significant explanatory power with regard to inflationary pressures over the past decade, and especially in the wake of extreme monetary accommodation in response to the COVID pandemic, which highlighted the increasingly archaic and unsustainable nature of traditional attitudes towards expansionary monetary policy, and trend towards policy-making excessively motivated by politics and short-term results. Extension of the monetarist argument to recent commodity-driven inflation, however, exceeds the realm of useful and realistic isolated application of the monetarist argument.

Nonetheless, as Friedman argued when questioned over 'cost-push' inflation in the 1970s during the lecture from where the titular quote originates,[20] current inflation remains a monetary phenomenon given the supply of goods and services relative to the money supply remains in decline, though this alone is of little use to policymakers and economists in the short term, given the abundance and magnitude of exogenous influence on price levels which can and should form the basis for policy with which to recover from the recent economic turmoil.

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