# Q1) "Inflation is always and everywhere a monetary phenomenon". Discuss in the context of the inflation the UK now faces.

Inflation has always been a central topic of debate for economists: is it a harbinger of economic doom, something to be controlled and minimised? Or, is its presence a facilitator for growth, a 'necessary evil', or otherwise what Abhijit Banerjee, a 2019 Economics Nobel Prize-winner, described as 'not a bad thing!'[1].

Regardless of which school of economic thought you subscribe to, it is agreed that inflation is a phenomenon here to stay. And, as inflation's main 'symptom' is a fall in the purchasing power of money, it is fair to describe it in the words of Milton Friedman as an inherent 'monetary phenomenon'. Although seemingly outdated, with Friedman's term first being coined in his speech in 1963[2], in a lucid way the premise of his statement is correct - however, Friedman also argued that inflation is directly correlated to the supply of money: his argument is summarised 'one [can] not find inflation anywhere [...] that was not caused by a prior increase in the supply of money or in [its] growth rate'[3]. Friedman's conventional view has long been debated, as has the idea of using monetary policy[4] to alter the money supply and reduce interest rates. This argument is particularly potent today when 71% of Britons are concerned about an increase in inflation and their cost of living over the next 12 months[5]: what is causing this inflation, and how does the government propose to control it?

The rate of increase in prices over time: the reason behind soaring nominal figures, and the cost of living crisis encroaching on the UK. A look to the current situation in Britain points to high inflation as an agent for recession. With the Bank of England's recent figure of 10.1%[6]; the UK is currently experiencing a disastrous concoction of demand-pull and cost-push inflation. With higher energy and food prices due to supply-side issues as a result of the ongoing Russo-Ukrainian war, the cost of UK imports rising due to increased bureaucracy surrounding trade with Europe, and due to various skill shortages leading businesses' costs to rise and further delays to production - the aim of low and stable inflation has been brought into the limelight. Monetary and fiscal intervention is needed now (more than ever) to bring inflation back into the Bank of England's target of 2% ( ±1%).

The main question being raised in the House of Commons is which government policies will help ease the burden of the cost of living crisis. As economic history shows, with records of

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[1] Business Standard, '*Inflation not a bad thing! Highlights of Abhijit Banerjee's take on economy*', [article], https://www.business-standard.com/article/economy-policy/inflation-not-a-bad-thing-highlights-of-abhijit-banerjee-s-take-on-economy-119102200316_1.html, 22 October 2019.

[2] Friedman, M., '*Inflation Causes and Consequences*', Asia Publishing House, [report], 1963.

[3] Henderson, D. R., '*Inflation: True and False*', Hoover Institution, [website], https://www.hoover.org/research/inflation-true-and-false, 20 May 2021.

[4] Such as the relatively recent use of quantitative easing

[5] Goodman, D., '*UK Consumers Most Worried in Major Economies About Inflation*', Bloomberg UK, [article], https://www.bloomberg.com/news/articles/2022-06-20/uk-consumers-most-worried-in-major-economies-about-inflation, 20 June 2022.

[6] The Bank of England , '*Inflation and the 2% target*', [website], https://www.bankofengland.co.uk/monetary-policy/inflation, 25 August 2022. All figures are recorded as of time of writing (August 2022)

hyperinflation, deflation, and recession, this is no easy feat. A report published by the Office for National Statistics (ONS) shows that between March and May of this year, there has been a 6.2% rise in nominal total pay[7]; this - coupled with the rise in inflation which is increasing at a rate faster than wages - means that real incomes have fallen by over 3%[8]. According to Modern Monetary Theorist, Stephanie Kelton, Kelton warns that what matters is 'whether average earnings are rising fast enough to keep up with rising prices[9]' to avoid a decline in the real standard of living. This proves particularly troublesome for the UK Government: the demand for higher wages by trade unions would increase UK firms' costs of production further, incentivising an increase in prices, and potentially lending to the formation of a wage-price spiral.

Another issue is that this rise in UK prices is not only exogenous, but expectantly 'temporary' - a stark contrast to the inflation described by Friedman as being caused by a change in the aggregate supply of money in an economy. In a study conducted by Paul De Grauwe and Magdalena Polan of around 160 countries over the period of 30 years[10] (designed to evaluate the long-term relationship between inflation and the growth rate of the money supply), an understanding of the current inflation situation in the UK can be inferred. Contrary to the Friedman-esque norm, Polan and De Grauwe discovered that 'the relation between inflation and money growth for low-inflation countries (on average less than 10% per year for 30 years) is weak, if not absent' and that for 'low-inflation countries, inflation and output growth seem to be *exogenously driven phenomena*, mostly *unrelated* to the growth rate of the money stock[11]'. Conversely then to the Quantity Theory of Money (QTM) headed by Friedman, Polan and De Grauwe do not see an increase in the money supply as a sole predecessor to inflation. Rather, they attribute more influence to exogenous factors, as currently seen in the UK today.

So, what is the government going to do? As the hustings for Prime Minister continue, Rishi Sunak and Liz Truss have proposed two varied solutions to help alleviate the effects of the 10.1% inflation rate on British citizens: the former proposes the implementation of a 'sustainable, long-term tax plan[12] that means people can bank the money it saves them'. Whilst the latter focuses on 'sustainable growth': 'growing the economy[12], [...] reforming the supply side, getting EU regulation off our statute books, and cutting taxes [to] tackle inflation in the long run'. Which policies are enacted will be determined in the upcoming months, however, the recent £37 million Cost of Living Support package[13] providing grants to

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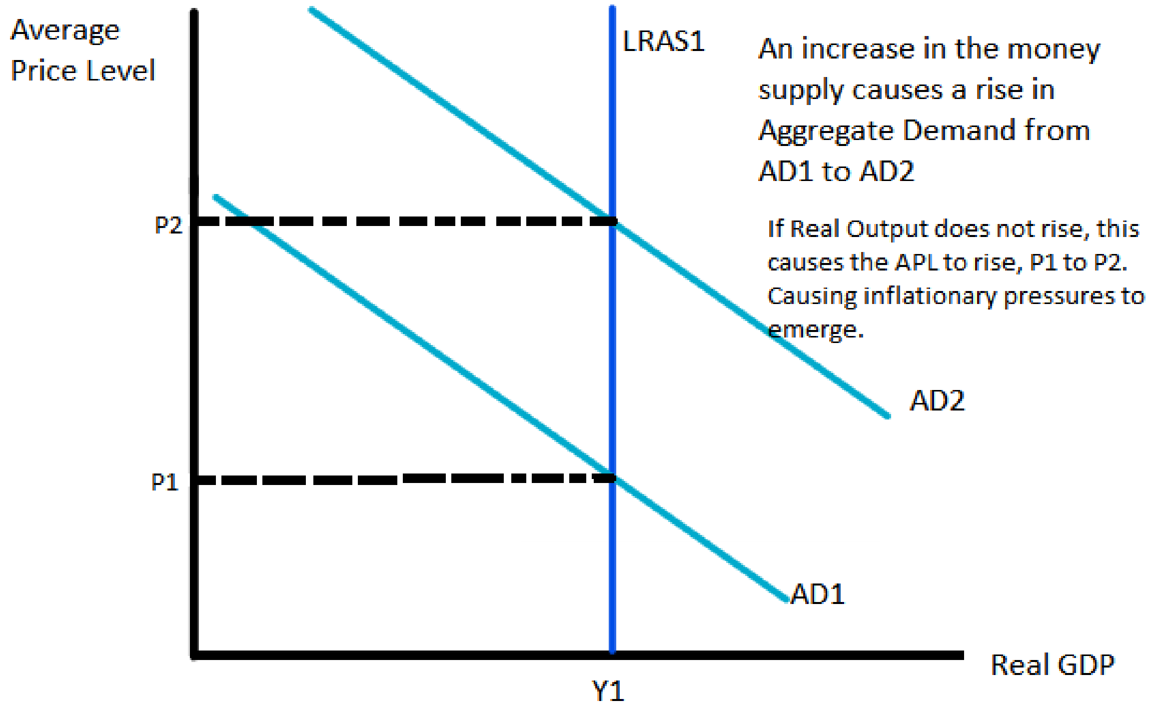
[7] Office for National Statistics, '*Average weekly earnings in Great Britain: July 2022*', [website], https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/july2022#:~:text=The%20rate%20of%20annual%20pay,pay%20growth%20has%20remained%20strong, 19 July 2022.
[8] Giles, C., '*Record wage drop signals more cost of living pain for UK households*', Financial Times, [article], https://www.ft.com/content/28f2b344-e2a6-4e10-bf4a-c924660eded0, 16 August 2022.
[9]Kelton, S., '*The Deficit Myth*', pp. 45-46, 2020.
[10] De Grauwe, P. D. and Polan, M., '*Is Inflation Always and Everywhere a Monetary Phenomenon?*', The Scandinavian Journal of Economics, vol. 107, no. 2, pp. 239–59, JSTOR, http://www.jstor.org/stable/3441104, June 2005.
[11]Emphasis added
[12] Merrick, J. and Singh, A., '*Rishi Sunak comes out fighting on inflation amid warning of rise to 15%*', inews, [article], https://inews.co.uk/news/politics/rishi-sunak-comes-out-fighting-inflation-amid-warning-rise-15-1777715, 3 August 2022.
[13]UK Government, '*£400 energy bills discount to support households this winter*', [press release], https://www.gov.uk/government/news/400-energy-bills-discount-to-support-households-this-winter#:~:text=The%20Energy

households unable to afford rising energy prices has already been enacted, and in theory will help maintain standards of living for those who have been most affected by the fall in real incomes. Apart from fiscal policy intervention, with inflation estimated to be ‘just over 13% in 2022 Q4[14]’ and to remain at ‘very elevated levels throughout much of 2023[14]’, many have been calling on the Bank of England to take a more aggressive approach to monetary policy. Criticising a ‘timid’ Bank of England, A zad Zangana calls for the Bank to ‘keep raising rates to a more restrictive level[15]’. However with estimated time lags of up to 18 months[16] for interest rates to filter through the economy, and inflation ‘forecast to peak in October[15]’, it is likely incomes and fiscal policy will take the limelight in controlling inflation over the upcoming months.

To further analyse the notion of inflation being a ‘monetary phenomenon’ in the context of the UK's current situation, a look to the ongoing debate within the economics community proves useful: whether inflation is caused directly and proportionately by increases in the money supply. Friedman was described as the inventor of ‘Monetarism’, however Steve Keen in his book ‘The New Economics: A Manifesto’ makes comparisons between Friedman’s view of money creation and its interaction with the private sector and inflation, in comparison to the newly popularised MMT lens on the notion. Keen is known for his emphatic critiques against Neoclassical economics - and this support for a ‘New’ Post-Keynesian school of economic thought is maintained in his argument surrounding whether inflation is a monetary phenomenon. In theory, there is a strong correlation between an increase in the money supply and inflation. As explained by Friedman himself, ‘Inflation is caused by one thing and one thing only - a more rapid increase in the quantity of money than in output[17]’. If the money supply rises faster than real output, then inflationary pressures will emerge, as shown by the Classical LRAS curve below[18] (where AS is inelastic in the long term).

%20Bills%20Support%20Scheme%20forms%20part%20of%20the%20government%27s,to%20the%20Energy%20Bill%20discount, 29 July 2022.
[14] Bank of England, ‘*Monetary Policy Report*’, Monetary Policy Committee, [report], https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2022/august/monetary-policy-report-august-2022.pdf, August 2022.
[15] Zangana, A., ‘*A timid BoE will mean higher for longer UK inflation*’, Schroders, [article], https://www.schroders.com/en/lu/professional-investor/insights/economics/a-timid-boe-will-mean-higher-for-longer-uk-inflation/, 17 July 2022.
[16] Gerlach, S. and Svensson, L. E.O., ‘*Money and Inflation in the Euro Area: A Case for Monetary Indicators?*’, NBER Working Papers 8025, National Bureau of Economic Research, Inc., [report], 2000.
[17] Friedman, M. and Pagan, D. W., ‘*A Monetarist View*’, The Journal of Economic Education, vol. 14, no. 4, pp.47, 1983.
[18] Diagram created for this essay

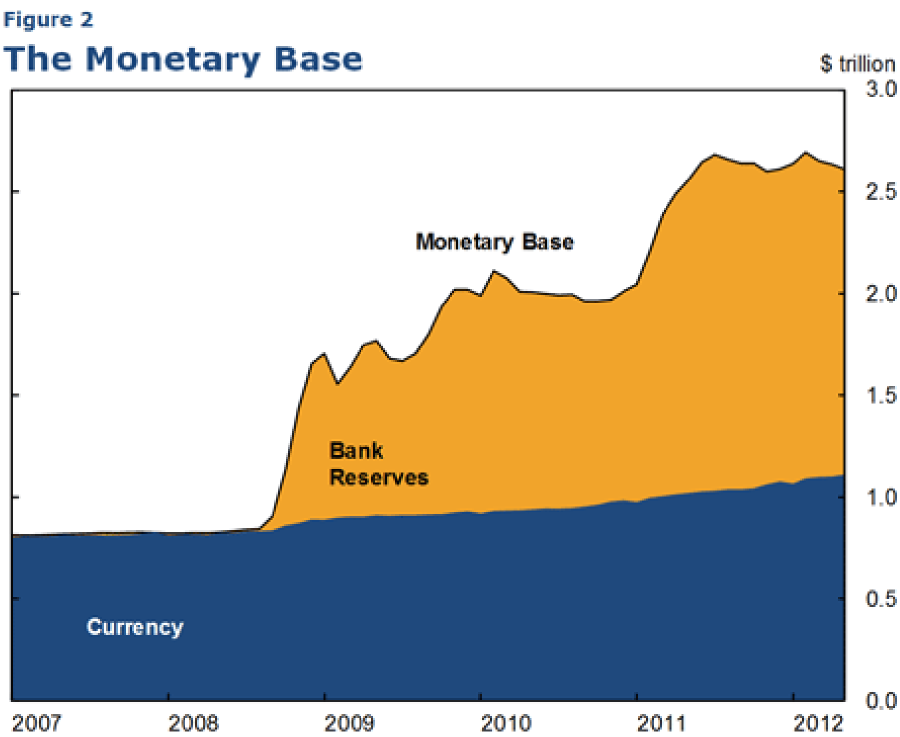



Keen, however, argues that although Friedman and Warren Mosler 'Both attribute money creation to government action, and that a government which pushes economic activity too high by creating too much money will cause inflation [but] behind these points of argument lie utterly different visions of how the government creates money[19]'. Rather than government spending being funded by 'borrowing from the private sector or from foreign governments', the modern system of fiat money renders central banks the ability to interface with the private sector 'indirectly' through 'bank deposits rather than coins or notes'. He argues that if Neoclassical economists accepted that 'bank lending creates money' and the 'repayment of bank debt destroys it', this factor alone, ignored by conventional economic theory, would explain the main reason behind the volatility of the money supply, and better inform economists to control inflation by focusing on controlling the 'short-term rate of interest' rather than trying to control 'the rate of growth of the money supply', and this, subsequently, would have helped in avoiding the recession the US experienced after the 1975-era of stagflation and high inflation rates of 19%. Other economists have also disagreed; for example, Chris Papadopoullos argues that 'Inflation [is] now a fiscal phenomenon[20]' and 'fiscal policy will probably be playing a role in aggregate demand and inflation that it hasn't played since the 1970s' - something the UK is forecast to see over the coming months too.

But is inflation really a monetary phenomenon? And is the inflation in the UK correlated to an increase in the money supply, as the 'long tradition of QTM[10]' would have us believe? Well yes, and no. As is required in much of economics, inferring economic causes from past inflationary events and cross-country analysis can provide useful insight on the current

[19] Keen, S., '*The New Economics: A Manifesto*', pp.39-45, 2022.
[20] Papadopoullos, C., '*Inflation now a fiscal phenomenon*', Official Monetary and Financial Institutions Forum, [article], https://www.omfif.org/2020/05/inflation-now-a-fiscal-phenomenon/, 13 May 2020.

situation in the UK. It is known that different countries have varying 'real factors'[21], as coined by Masaaki Shirakawa[22]', however a look to the US can prove insightful. Over the past four years the Federal Reserve has 'more than tripled[23]' the monetary base (as shown below)[24] and despite warnings that such a large expansion of the monetary base would 'inexorably' cause high inflation 'à la Friedman[23]', John C. Williams, CEO of the Federal Reserve Bank of New York, states that America has been the 'dog that didn't bark'. He believes that 'recent developments make a compelling case that traditional textbook views of the connections between monetary policy, money, and inflation are outdated and need to be revised'. Potentially leading economists to believe that an increase in the supply of money does not always equate to a rise in the general level of prices.




But the recent quantitative easing carried out by the UK does conform to Friedman's, and economist Robert Vogel's conclusion that there are 'proportionate changes in inflation rate within two years of changes in money growth[25]'. Although not quite proportional, the inflation rate of the UK does mirror the increase of the money stock enacted two years ago during the Covid-19 Pandemic, as shown by the two graphs below - one depicting the UK's

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[21]Shirakawa's real factors are factors such as dependency rates and demographic changes, factors that differ between countries and affect their economies distinctively.

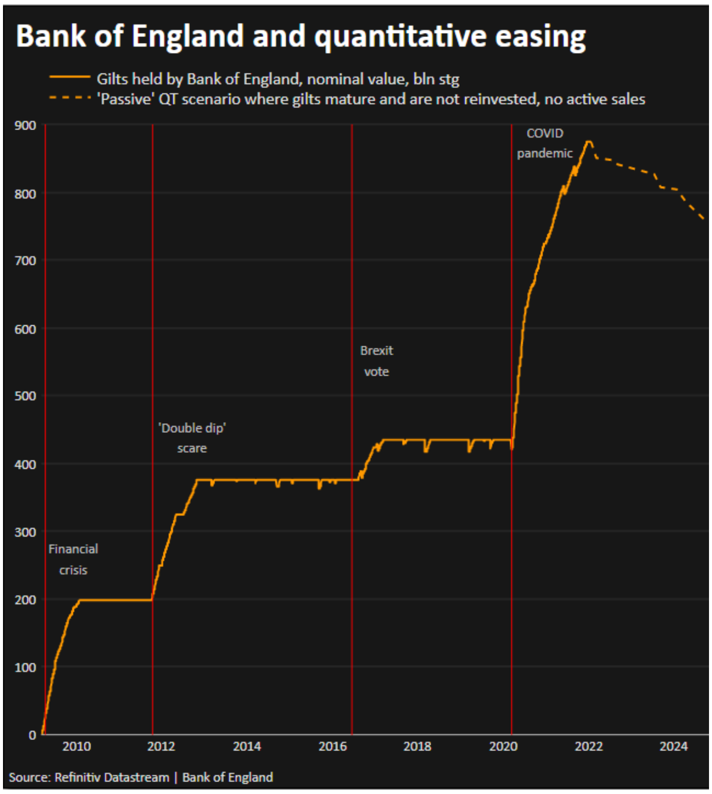
[22]Shirakawa, M., *'Is inflation (or deflation) "always and everywhere" a monetary phenomenon? My intellectual journey in central banking'*, BIS Papers No 77, [report], https://www.bis.org/publ/bppdf/bispap77e.pdf, 6 October 2014.

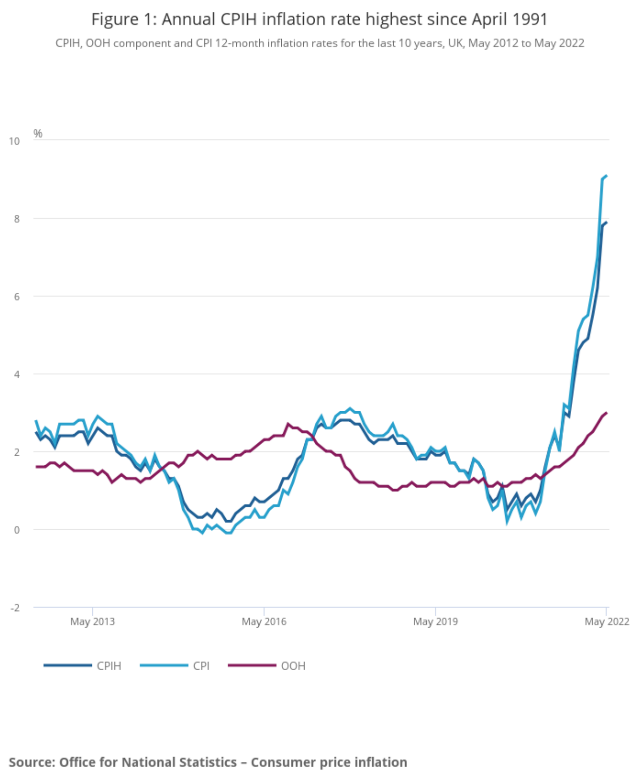
[23] Williams, J. C., '*Monetary Policy, Money, and Inflation*', Federal Reserve Bank of of San Francisco, [presentation], https://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2012/july/williams-monetary-policy-money-inflation/#figure1, 2 July 2012.

[24]Graph sourced from Federal Reserve Bank of San Francisco (Linked above)

[25] Vogel, R. C.,'*The Dynamics of Inflation in Latin America, 1950-1969'*, [report], American Economic Review 64, pp102-114, 1974.

quantitative easing of £450 billion over the course of 2020[26], and the other showing the UK's inflation rate over the past decade.




To conclude, the situation in the UK is an amalgamation of various factors, all contributing to the Bank of England's 10.1% figure. A step away from Friedman's view of inflation as a 'monetary phenomenon' may be necessary in the context of the UK, as this exact combination of external factors has never been seen before in economic history. It may be up to further debate whether inflation is 'always' a monetary phenomenon, as the growth of heterodox economics increases pressure behind once-accepted theories from former Monetary and Neoclassical economists. Up until recently, as the causes of this inflation were largely external and 'transient', the Bank and the British Government were hesitant on employing any deflationary policies that may affect economic growth as the country had already experienced one-quarter of negative growth[27]. However, as time has passed Andrew Bailey has announced that although: 'there were reasons to believe that it would end and [we'd return] to a degree of normality. The problem is we've now had a second shock' meaning both exogenous factors (like the cost of energy and rising food prices), and money stock-related inflationary pressures have all affected the UK at the same time- making what

[26]Bank of England, '*What is quantitative easing?*', [website], https://www.bankofengland.co.uk/monetary-policy/quantitative-easing, 19 May 2022.
[27] Office for National Statistics, 'GDP first quarterly estimate, UK: April to June 2022', [website], https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/apriltojune2022, 12 August 2022.

was 'transient' inflation, much more long-lasting. Although the Bank of England has increased interest rates to 1.75%[28], much more drastic and immediate changes to fiscal, monetary, and incomes policy will be needed over the coming months to help control inflation, and support Britons facing rising prices and a fall in their real incomes.

***Word Count: 1989 (Body Text Only)***

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[28]Bank of England, '*Bank Rate increased to 1.75% - August 2022*', https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2022/august-2022, August 2022.

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