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The logic of inflation

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Notes for the Series: Economic Briefs

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The objective is to disseminate these briefs as resources for workshops and discussion sessions in volunteer groups, NGOs and academia to evaluate the topics covered to provide a basis for transparent analysis and the development of beneficial propositions for improved alternative policies.

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The logic of inflation

In the Economic Briefs series, the theme of the cause of inflation comes up often.

The basic contention between Keynesians and monetarists (KM), on the one hand, and the Real Income Approach (RIO)[1] developed by Hector McNeill, on the other, is that:

- KM consider inflation to be caused by ***excessive demand*** or ***money volumes***
- RIO considers inflation to be mainly ***cost-push*** originated

Logic

Under competitive conditions companies only sell products of equivalent quality by meeting or lowering their prices in relation to the competition. It can be the case on a temporary basis that, if there is an interruption in production or supply chain operations, some buyers will be prepared to pay more to obtain their desired requirements. Such circumstances are similar to a growth in demand not being met by an equivalent rise in supply causing a rise in unit prices. In such cases the incentive of producers to increase production and supply in response to the price rises would normally result in unit prices, under competitive conditions, returning to the levels before the shortage.

No amount of money in circulation alters the discipline imposed on each producer by competition to set prices at levels which ensure sales and therefore there is no direct impact of money volumes on prices.

In technical terms money volume have no impact of the price elasticity of consumption or the price elasticity of demand. In other words what is sold has a transactional price determined by wage purchasing power and consumer disposable income and consumption needs profiles. Indeed, with the requirements of consumption having been satisfied in the supply side production of goods, services and capital equipment any additional money would be saved or invested in asset markets. Therefore the "excess" money does not affect supply side prices or wage earner cost of living items because it has move to encapsulated markets[2].

The consequences of excess funds to consumption requirements

Any excess fund to consumption needs tend to flow into 8 distinct markets, including:

- Non-circulating encapsulated markets
    - Land and real estate - r
    - Precious metals - p
    - Commodities - m
    - Art objects - a
    - Shares - h
    - Financial instruments - f
    - Crypto-currencies – c
    - Offshore investment - o

- Circulating open markets
    - Supply side production and consumption of goods, services and capital equipment in exchange for wages - w

[1] In 2020, the Real Incomes Approach was rebranded as the slogan, "RIO-Real Incomes Objective.

[2] Encapsulated markets are well-defined markets with a limited specialised participation, usually of a very small number of constituents. The money in these markets does not generally flow into the supply side markets and therefore does not contribute to corporate inputs or payment of wages. On the other hand, these can have a very high value as a result of speculative forces. For example, the grey financial instruments markets are larger than the recorded supply side GNPs in several countries. The term "encapsulated market" first appeared in 2020 in RIO research and development work papers.

- Savings - s

Except for offshore investment the encapsulated markets are all speculative asset markets within which less than 5% of the population participate as asset holders and/or dealers.

When offshore investment generates offshore profits that are reinvested or held offshore, then offshore investment becomes a noncirculating encapsulated market in relation to the onshore economy. The circulating open markets are where something like 95% of the populations work and earn their living. Under quantitative easing and close to zero interest rates, savings "markets" are reduced in size.

How asset markets create cost-push inflation in supply side inputs and reduce purchasing power of wages.

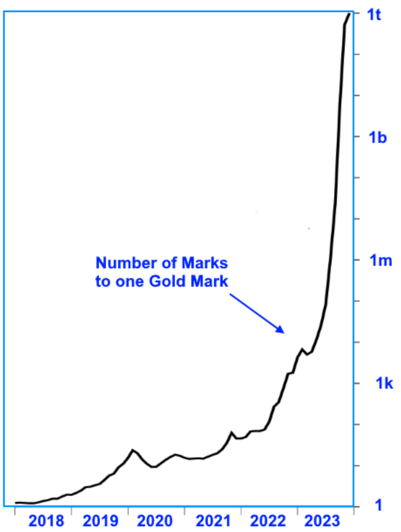
The speculative rises of prices in the land and real estate markets can be very high and can exceed the rate of increase in wage rises if any have occurred. The rises in land and real estate prices leak into the supply side as costs to business as well as to wage earners. Prices and rents for the following inputs rise:

- Land
- Houses
- Retail units
- Office space
- Industrial units
- Warehouses
- Port facilities
- Some commodities

As a result, these prices or rents of inputs create cost-push inflation and in the case of wage earners a rise in the cost of living.

Hyperinflation

Very often the standard reference to the negative consequences of inflation is the Weimar Republic or the situation of Germany between 2018 and 2023 following the end of the First World War when the handling of reparations and the treatment of Germany by the victors was destabilizing. There is a direct correlation between the money in circulation and the level of circulation but money volumes as such were not the cause of information.



Logic

The most relevant analysis of its cause was part of the analysis undertaken during the development of RIO in Brazil in 1975-1976.

Cost-push inflation caused by rising petroleum prices created inflation. Companies became concerned that the high rate of inflation which was essentially an exogenous factor (international price of petroleum) was raising input costs and this phenomenon ran down the supply chain to final consumers. Because neither Keynesianism or monetarism had solutions the circumstances surrounding confidence in the ability of the government to contain inflation was low. Therefore, in order to maintain the real purchasing power of inform and profits to survive into the future as well as to keep workers employed, companies anticipated future inflationary devaluations of the currency by raising prices beyond the current rates of inflation. As a result, this resulted in a continuation but accelerated rate of inflation in supply side goods and services. However, this is not caused by the volume of money in circulation but it rather a logic price setting strategy adopted by companies to sustain the value of their cash flow.