THE GLOBE AND MAIL

OPINION

# Inflation is about a lot more than just the rising cost of living

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PUBLISHED YESTERDAY

The latest edition of the consumer price index, showing an increase of 4.8 per cent comparing this December to the last – the highest annual increase in 30 years – has added new fuel to the debate over inflation. Should it?

Inflation is not rising prices. Rising prices are not inflation. They can be evidence of inflation, but are not necessarily so. Likewise, inflation can exist even where prices are not rising, as under price controls. Inflation, properly understood, is not a phenomenon of prices at all. Inflation is a decline in the value of money.

A rise in the price of oranges is not, on its own, inflation. There might have been a spate of bad weather in an important orange-growing region, or some other supply disruption. Rising orange prices, in that context, are an appropriate signal of the relative scarcity of oranges, encouraging consumers to ration their demand and producers in other regions to increase their supply.

If a number of different goods and services simultaneously experience such an increase in price, for reasons particular to each, that too may look like inflation, so far as these separate increases combine to produce an increase in the average price level.

But it is not, in itself, inflation, nor even proof that inflation is at hand. The increase in prices is neither generalized nor sustained, of a kind that suggests a decline in the value of money. Rather it is a one-off increase in the price of *some* goods relative to *other* goods.

Neither is the cause of inflation simply "too much money chasing too few goods." The more accurate formulation is "too much supply of money relative to the demand." Where the

demand for money, relative to total spending in the economy, is a constant, an increase in the relative abundance of money can be expected, over time, to lead to a decline in its value, and ordinarily this should be reflected in a generalized increase in prices. The long-run correlation between growth in the money supply and inflation is incontrovertible.

In the short term, however, the demand for money can often jump about in ways that are hard to predict. In a crisis, for example, people often want to hold onto more money than they usually would, as a buffer. In the face of such a spike in the demand for money, a given increase in money supply will not have the same inflationary effect as it might otherwise.

The two false equations – between inflation and higher prices, and between growth in the money supply and higher inflation – are the source of much present confusion. The pandemic elicited two broad responses from governments around the world: on the one hand, broad lockdowns of economic activity, which continue to a greater or lesser extent to this day; and on the other, massive increases in spending, financed in large part by central banks.

As the lockdowns were lifted, more rapidly in some parts of the global economy than in others, it was to be expected there would be some dislocations, where the supply of a particular good struggled to keep up with the demand. It was also to be expected that the combined effect of these disparate relative price movements would be a large short-term rise in the average price level.

But because there was at the same time such a large increase in most countries' money supply, it was easy to lump all of these relative price hikes together as inflation, and to ascribe this seeming inflation to the policies of the central banks. The argument may even be true. It's just that it is not *necessarily* true – not as an explanation of what *has* happened, and certainly not as a prediction of what *will* happen.

Whether or not the price increases observed over the past year translate into continuing inflation in future will depend very much on what central banks do next. Measured against prepandemic levels, prices overall have not increased by as much as current year-on-year numbers would suggest. More recent figures, moreover, suggest the pace of price increases may already have begun to slow.

But a monetary policy that might have been non-inflationary in a crisis can turn inflationary once the crisis has passed. Much of the current hysteria on the opposition

benches seems to be predicated on the assumption that the Bank of Canada is either unaware of this, or choosing to ignore it.

The Bank's actions would seem to refute this: it has already stopped net new purchases of government bonds, and has signalled its intention to begin raising interest rates. As important as the Bank's actual policies, however, is the public's understanding of them. People must believe both that the Bank has the power to keep inflation in check, and that it intends to do so.

Of the first there is no doubt: inflation is, ultimately, a monetary phenomenon, if not "always and everywhere" then at least "overall and in the long run." But there might be room for doubt on the second: because it might be painful, economically, and because the knock-on effects of a failing economy on our already massive debt levels, public and private, would be horrific.

Worse, if people expect inflation to continue or even rise on that basis, and if that expectation is reflected in their wage and price demands, it becomes more costly still to bring it back to earth – it is always harder to row against expectations than with them – perhaps making the Bank still more reluctant, and entrenching expectations still more firmly.

So the Bank will want to move more quickly than it might, if it were only concerned with actual inflation, rather than expectations of it. Does the Bank have to, though? Couldn't we just "learn to live with" inflation, as we are told we must learn to live with COVID, or Russian aggression? No, and for much the same reason: because the longer you put off dealing with it, the greater the cost becomes.

The costs of inflation are not simply the rise in the "cost of living." The greater cost, rather, lies in the declining value of money. (Remember: inflation is not rising prices.) Without a reliable standard of value, it becomes difficult to know whether an increase in the price of this or that good is a relative price increase – information, that is, of a kind one might profitably act upon – or simply part of a generalized increase in prices, which one should ignore.

The level of inflation adds an additional layer of uncertainty: higher inflation rates tend also to be more unstable. Uncertainty means risk, requiring a premium to cover it – on prices, on wages, and especially on interest rates. It also leads to disagreements, as between

management and labour: inflationary periods are typically marked by higher numbers of strikes.

The whole of the economy is given over to guessing the future course of inflation – not least when it will end. Much further misinvestment is based on the belief, or perhaps the hope, that inflation will go on forever – that in the crunch the authorities will always cave, rather than spoil the party. Which invariably proves to be true, until it is false.

The greatest cost of inflation is bringing it to an end. Which is not an argument for not ending it, but for never letting it get started.