A Marxist theory of inflation

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Michael Roberts, August 21, 2020

In my previous post on inflation, I spelt out why mainstream theories of inflation have been proved wrong empirically; leaving mainstream economics in a confusion about what just does drive inflation in the prices of goods and services. In this post, I want to argue that mainstream theories of inflation falter because they are not based on the law of value that operates in the capitalist mode of production. Both the monetarist and Keynesian theories fail because of this.

Marx opposed both these mainstream theories. The quantity theory of money was opposed by Marx for two reasons: 1) money is endogenous, created by banks etc, not by state fiat; 2) overall, money represents value in commodity production and is not independent of it.

So returning to the quantity theory of money equation, MV=PT (see the previous post); for Marx, the basic causal direction is from PT to MV, not the other way (ie from prices to money, not money to prices). Money is endogenous to capitalist production and prices of production are formed from value creation not from money creation. Money supply generally will follow price changes, so deliberate attempts to alter the money supply will fail to determine price inflation.

Cost-push theories were also rejected by Marx because wage rises do not cause price rises. As Marx put it in Value, Price and Profit, when he debated with trade unionist Weston who argued that wage rises would cause inflation: *"a struggle for a rise of wages follows only in the track of previous changes, and is the necessary offspring of previous changes in the amount of production, the productive powers of labour, the value of labour, the value of money, the extent or the intensity of labour extracted, the fluctuations of market prices, dependent upon the fluctuations of demand and supply, and consistent with the different phases of the industrial cycle; in one word, as reactions of labour against the previous action of capital* (my emphasis)."

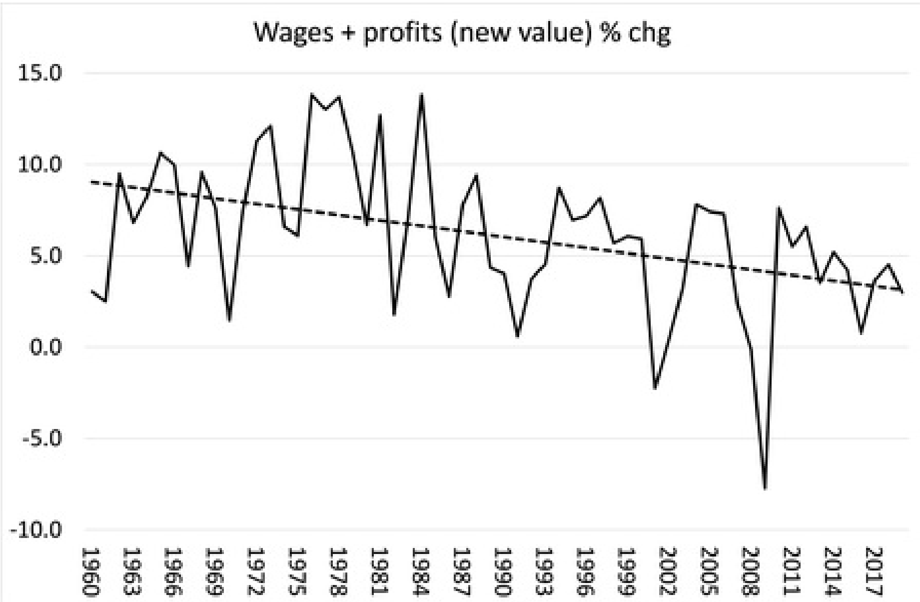
"By treating the struggle for a rise of wages independently of all these circumstances, by looking only upon the change of wages, and overlooking all other changes from which they emanate, you proceed from a false premise in order to arrive at false conclusions." Broadly speaking, argued Marx, *"A general rise in the rate of wages would result in a fall of the general rate of profit, but not affect the prices of commodities."*

Marx never developed a comprehensive theory of inflation, but can we develop one based on Marx's value theory? Italian Marxist economist, Guglielmo Carchedi has come up with one. His work will be fully published later this year. But let summarise his main arguments.

Capitalist production continually strives to increase the productivity of labour ie produce more units per worker. But this means that the labour time per unit will fall. As only labour creates value, while there is a general tendency for the *supply* of units of goods and services to rise, there is also a general tendency for the *value* of commodities to fall, over the long term. This is because capitalist accumulation is a labour-saving process, so the value of commodities will fall alongside a rise in the productivity of labour. Use values are produced at greater amounts than the value contained in them. So, if prices of production depend on value, there is an inherent tendency for prices of commodities to fall not rise. as total value will fall relatively to total production over time.

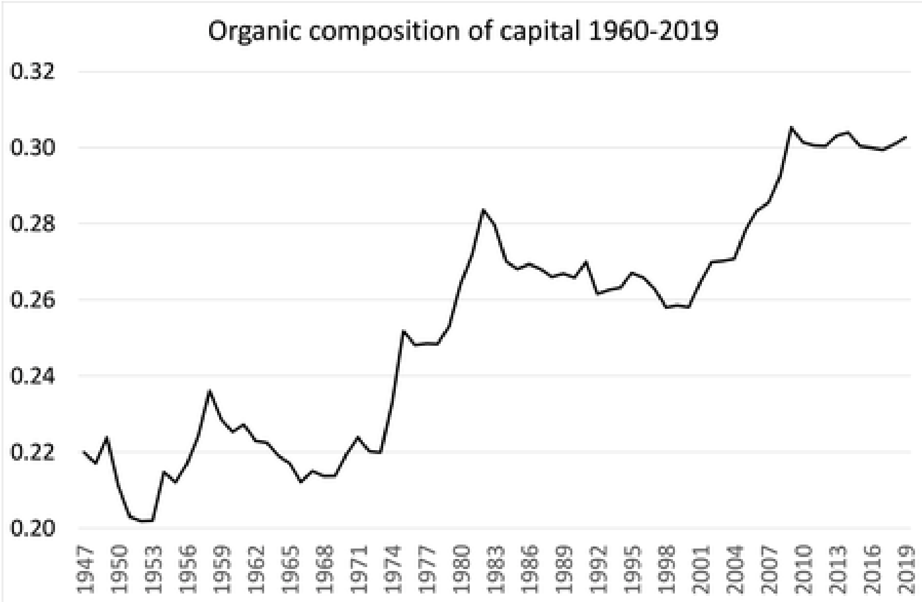
The demand for commodities depends on the new value created in production. New value commands the demand or purchasing power over the supply of commodities. New value is divided by the class struggle into wages and profits. Wages buy consumer goods and profits buy capital or investment goods.

But new value will tend to decline: first, because total value declines relatively to the supply of commodities…



Source: author's calculations from NIPA GDP data

… and second because of the rising organic composition of capital (c/v). Capitalist accumulation is labour-saving, so the value of machinery, plant, and raw materials etc (c) will tend to rise relative to the value of labour power (v). As the price of production in value terms is made up of constant capital (c) and new value (v+s), a rising c/v will tend to reduce the share of new value in the price of production.



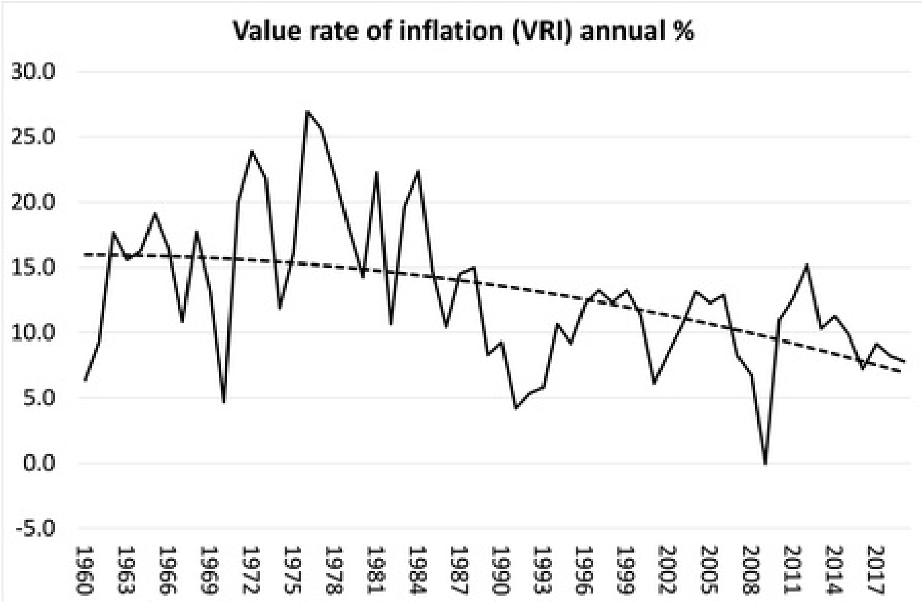
Source: author's calculations

Total value will decline relatively to use value production and new value will decline relatively to total value. So there is an underlying deflationary or disinflationary pressure on the prices of commodities over the long term.

But there are counteracting factors that can exert an upward pressure on prices over the long term; in particular, the intervention of the monetary authorities with their attempts to control the supply of money.

Carchedi's theory of inflation is that there is a value rate of inflation (VRI), which combines the impact of changes in the purchasing power of wages and profits (new value) and the money supply, measured as cash deposits in banks (M2). The former factor is the determining one and will tend to drive price inflation down, while the latter is the counteracting factor that will tend to push inflation up, but with no permanent success.

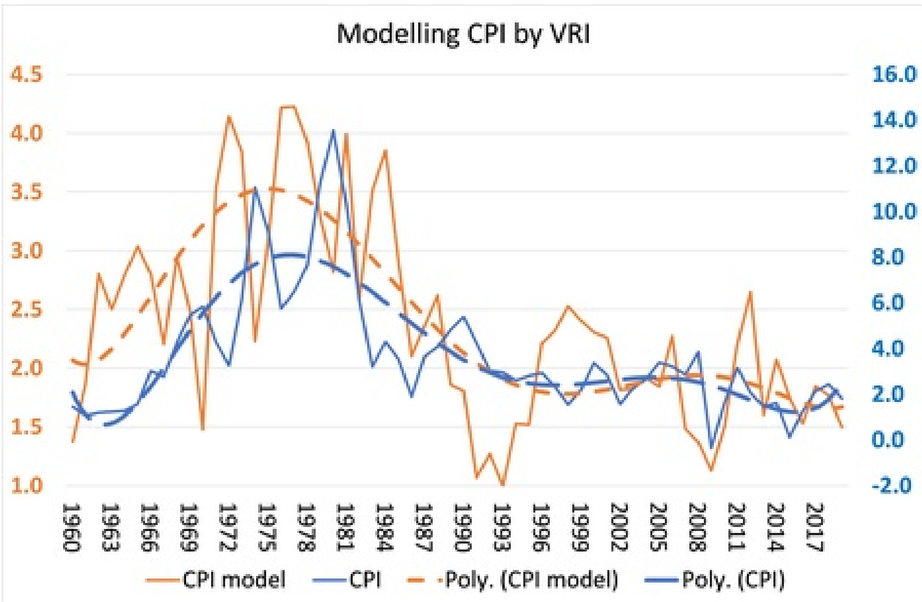
The value rate of inflation (VRI) = % change in wages and profits (CPP) + % change in money supply (M2). Using data from the US since 1960, we find that the VRI falls over the long term. This is because the combined purchasing power (CPP) of wages and profits grows more slowly and any changes in money supply (M2) have been insufficient to stop the VRI slowing.



Source: author's calculations

But is there a close correlation between the VRI and consumer price inflation? Yes. Between 1960 and 1979, the VRI rose and so did US CPI inflation; between 1980 and 2019, the VRI slowed and so did CPI inflation.

Indeed, if we model the VRI forecasts for each year against actual CPI inflation, there is a close correlation over the long term. In the graph below, the VRI inflation model forecast for US consumer price inflation (orange lines) is a pretty good fit for actual CPI inflation (blue lines). It offers a much better result than monetarist forecasts or the Phillips curve, especially since the early 1990s, the period of so-called disinflation that has puzzled monetarists and Keynesians.



The value theory of inflation thus explains the slowdown in annual consumer price inflation since the 1980s, unlike mainstream theories which are nonplussed. Even though central banks pumped more money into the economy and M2 money supply growth accelerated, especially from the 1990s and after the Great Recession, because new value growth kept slowing, the slowing combined purchasing power of wage and profit growth continued to drive down inflation.

Can we forecast where inflation is going in the COVID and after? If Carchedi's theory is right, then whether inflation returns after the COVID depends your forecasts for new value and M2 money growth and thus on the forecast for the value rate of inflation. When he reads this, Carchedi will complain that the value theory of inflation is long term and cannot be used to forecast inflation over a few years or less. But nevertheless, let's have a go.

This year, 2020, has seen a huge rise in M2 money supply, up 25% yoy so far. But we can expect a fall in profits of about 25% and in wages of about 20% – so a big drop in the combined purchasing power of new value. The VRI model translates into US consumer price inflation this year of about 0.5-1.0%, an annual rate not seen since the depth of the Great Recession. Currently US CPI annual inflation is at 1.0% in July after falling to 0.7% in June.

If we assume that in each of the two next years, 2021 and 2022,the nominal wage bill rises by 5% and profits rise by 10% and 15% respectively, while M2 money growth slows to 10% a year, then the VRI model forecasts 3.0-3.5% US CPI annual inflation over the next two years, not deflation as some expect.

Of course, that result depends on the assumptions. More important, what the value theory of inflation shows is that mainstream theories of inflation fail because of their ignorance of value theory. Once changes in *value*, not money or employment, are analysed, we can understand the trajectory of inflation under capitalist production.

This post in no way covers all the points and arguments in the Value Theory of Inflation. They will be developed in detail in an upcoming academic paper and as part of the jointly authored book, Through the Prism of Value that Carchedi and I will publish next year.