The Deflationary Bloc

Phenomenal World

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— Yakov Feygin

"An effective way to write the history of the last thirty years of the twentieth century," economist Albert Hirschman wrote in 1985, "may well be to focus on the distinctive reactions of various countries to the identical issue of worldwide inflation." Writing just as the global "great inflation" of the 1970s was abating, Hirschman couldn't have foreseen how right he was. As Claudia Sahm recently wrote in the New York Times, fear of the great inflation of the 1970s still dominates the thinking of the Federal Reserve, even as its recent messages indicate changing winds. (In recent comments, Larry Summers's warning that two-thousand-dollar checks would cause the economy to run too "hot" and generate inflation betrayed an almost generational blindness on the topic.)

Economists lack a good understanding of what causes inflation. In introductory macroeconomics curricula, the mantra of Milton Friedman remains central: "inflation is always a monetary phenomenon." By this, Friedman meant that excessive price growth happens when a state loosens the supply of money, thus over-expanding the monetary base. But recent research has brought this popular doctrine into question. While expanding the money supply seems to be a necessary condition for uncontrolled inflation to occur, it is not sufficient: increases of the monetary base have occurred without any inflationary episodes, and inflationary episodes have happened with only very small increases in monetary base.

Contra Friedman, Hirschman suggested that uncontrolled inflation is primarily a political phenomenon that occurs when groups compete over resources. The rapid increase of the price level is a signal that the state can no longer control this competition. What exactly happened in the waning decades of the twentieth century, and why do the ghosts of inflation still haunt our economic and political reality?

Hyman Minsky's writings on the collapse of the so-called golden age of capitalism offer some insight by forcing us to engage with how distributive struggles have driven the inflationary and deflationary cycles of the past fifty years. In doing so, we can construct an account of the political economy underpinning the "deflationary coalition" that rules the common sense of our economic policymakers and the policy they write—and the path to a new one.

Hyman Minsky's moment

Minsky became posthumously famous as a prophet of the inherent instability of financial markets. The term "Minsky moment"—the point where a bubble caused by the accumulation of private debt bursts—was coined by PIMCO's Paul McCauley in the context of the 1998 Russian financial crisis and has become ubiquitous in the financial media. But Minsky's Financial Instability Hypothesis (FIH), the idea that capitalism has a tendency toward financial crisis, was part of a more elaborate theory of advanced capitalist economies. Minsky believed that as a financial system, capitalism was best defined by the fact that all economic units, including individuals and households, must survive by making cash inflows and matching commitments. This is what he called a "survival constraint": everyone from industrial firms to individual workers must have cash on hand to pay their debts or else find credit to roll their liabilities over to some future date when they will have cash flows. The ways that societies arrange for the extension and management of these cash flows and credit is a function of their institutions. For Minsky, changes in capitalist distribution and price dynamics can be understood by studying the evolution of these regimes in historical time.

In his first book-length work, *John Maynard Keynes*, Minsky analyzed what he called "big government" capitalism. His goal was two-fold. First, he sought to re-interpret Keynes by distinguishing the so-called hydraulic Keynesianism of the postwar era from the author's actual written work. He argued that postwar governments which boosted inflation through private profits contradicted Keynes' original system. Keynes believed that the state should facilitate long term economic development by directly planning economic activity, including the distribution of investment over the long run. Postwar American policymakers, however, created a policy that protected private sector profits during downturns. The United States government did not create the structures which could sustain the production of a baseline basket of goods and services from market instability during upswings. Instead, it pumped up aggregate demand via employment in the military-industrial complex and its attendant investment goods.

The second goal of the book was to warn about the inflationary tendencies of this approach. Government was forcing "overinvestment" in capital intensive industries like auto manufacturing and aerospace. While this created good jobs, it also meant that workers would have more money to spend on things made by less capital intensive, nondurable consumer goods industries. Wage inequality between these two sectors caused increasing industrial conflict. In the United States and Western Europe, a pattern emerged in which managers made wage concessions to the most highly productive workers to keep at bay demands for greater union participation in company decisions, thereby further increasing the demand for consumer goods.

Because returns to capital intensive goods were high, the investment capital needed to expand capacity in consumer goods was scarce. With rapidly increasing demand, the price of these goods began to rise, leading to a wage-price spiral. In industries with no anticipated profits, capitalists had no incentive to expand capacity. Consequently, output remained stable while prices rose. In the labor market, some workers held on to their jobs while others were relegated to chronic underemployment.

Minsky's account differs significantly from those we see in most textbooks. In Minsky's world, it is not the supply of money that drives the inflationary process but rather developments in the real economy. It is the *demand* for money that causes the expansion of the availability of the means of payment through the issuance of privately-issued bank credit that can be used to purchase goods. Thus, the supply of money is *endogenous* to the economic system rather than *exogenously* given by the central bank. In a modern capitalist economy, the central bank's role is twofold: it tries to set the price of credit money by acting as an outsized player, and it determines which private credit can be accepted as collateral for government credit—cash or reserves—which remain the "best" means of payment relative to private money. It's not the ability of central banks to print money, but their ability to contract and expand the issuance of credit money, that fuels economic expansions.

Importantly, Minsky argued that the policy prescriptions of so-called hydraulic Keynesians originated in a dramatic misreading of Keynes' understanding of equilibrium. While the hydraulic Keynesians sought to restore long-term equilibrium through short-run interventions aimed at preserving private profits, Keynes held that there was no equilibrium course set by supply and demand. Instead, the key relationship was between the profit expectations of investors and the workers' final consumption of produced goods. Propping up private profits would do nothing to help rectify these imbalances and instead only create financial instability, driving markups by capitalists realizing their investments. Stable when supported by a highly regulated banking system, "big government capitalism" was therefore vulnerable to bottlenecks caused by the maldistribution of demand across social groups.

From big government to money manager Capitalism

Starting in the late-1960s, banking in the global economy was increasingly deregulated, and domestic markets began to feel the pressures of inflation. The process began with the erosion of the American balance of payments. As countries recovered from the Second World War, increased imports drove down the price of the dollar relative to gold. Greater international business activity also demanded new sources of credit, which, under Bretton Woods, was restricted by capital controls. This tension gave way to the formation of the Eurodollar market, in which dollar-denominated credit instruments were issued by non-US-domiciled banks. Eurodollars could be used in transactions like money, but, unlike onshore dollars, Eurodollars in the 1960s and 1970s did not yet have an official backstop, and central banks could not control their issuance. The credit supply began to expand and there was no global response to limit it.

Underlying these proximate causes of growing inflation were the fundamental issues of investment and distribution. The Vietnam-era boom in employment accompanied the growing disparity in wage growth across the high-investment producer goods and lower-investment consumer goods industries. Increasing wages in one sector triggered conflict over wages in the other. This spiral caused a growth in imbalances between wage growth and the availability of consumption goods. This rendered American firms uncompetitive, leading to even more imports and thus destabilizing the Bretton Woods system. As the value of the dollar fell, oil producers increased prices, further lowering profit expectations and disincentivizing investment across the economy.

If input prices of key commodities—especially oil—were stable, then new demand from workers could have been absorbed by the expansion of new capacity. But the supply side shock of rising energy prices restricted an expansion of investment into the sectors that could satisfy growing demand and thus maintain the overall profits of investors. To realize profits, firms responded by raising prices. The 1970s infamously became an era of "stagflation"—high inflation and slow growth—across the industrialized world.

To deal with stagflation, governments transitioned to a system which Minsky labeled "money manager capitalism." This new system was marked by a rapid deregulation of finance and the creation of an economy in which managers of large concentrations of privately-created credit money met credit commitments through quick returns on investment. As a system, it was less stable and more anemic than its big government predecessor, but also less prone to inflation. Importantly, the latter shifted from wages and consumer good prices to financial assets. Credit expansion enabled the purchase and repurchase of financial assets, bidding up their prices irrespective of investment. In doing so, it allowed governments to halt inflation in consumer goods, at the cost of shifting investment away from the real economy and into the financial sector.

In a 1983 paper, Minsky considered this Friedman-inspired, Volcker-enacted approach:

> The monetarist experiment of 1979-82 demonstrated that if policy is willing to tolerate large scale unused capacity and massive unemployment, transitory success against inflation can be achieved. However, there can be no demonstration that unemployment can be reduced without reestablishing inflation. In as much as the recent price stability was accomplished while the power of the oil cartel was weakened and as a rising dollar contributed to low dollar prices for imports, it is not at all clear that the inflation rate will not jump when these two developments abate.[1]

Minsky correctly points out that the "Volcker Shock" ended the era of stagflation by destroying the demand for money. It wasn't the reduction of the state's money supply, but the absolute destruction of the private economy that ended the great inflation. And it was changes in the real economy that made Volcker's shock sustainable. The breaking of the OPEC cartel and the defeat of the labor movement destroyed the barrier to expanding investment and reduced the power of labor to bargain for wages.

What Minsky did not predict was that this situation would persist for a very long time. In the United States and around the world, deflationary political coalitions have proved to be very durable.

Asset capitalism and the deflationary coalition

Despite taking place in different contexts, the processes which allowed for the formation of deflationary coalitions exhibited some common features: governments empowered rentiers, gave some citizens nominal gains as consumers, ensured access to certain classes of growth assets for powerful constituencies, and repurposed the institutions of "big government capitalism" to support financial deregulation. Redistributing gains away from workers, financial deregulation integrated global economies in a manner that allowed states to pursue growth strategies benefiting an exclusive class of rentiers. This new class supported deflationary policies long after inflation posed an imminent threat.

In the United States, financial deregulation and its attendant deflationary political coalition were embedded in the politics of housing. Housing policy has been integrated with welfare provision since the New Deal, when the Federal Government intervened in credit markets to create a thirty-year fixed mortgage and allow for widespread homeownership. But as Greta Krippner has shown, the stability of this system depended on strict financial regulations that limited the interest rates that banks could charge on deposits. The "savings and loans" bank industry was specifically dedicated to issuing government-backstopped, thirty-year fixed loans. The inflation of the 1970s threatened this system of housing provision, as savers searching for higher returns pulled their money out of savings and loans, and invested it in new, unregulated products like Certificates of Deposit (CDs). Re-regulating these new instruments would carry a high political cost, but neglecting them would risk destroying the housing market.

In response, American policy makers reacted by deregulating lending while maintaining government protection for housing relative to other consumer borrowing. Thus, housing became a special kind of asset that could both be widely held and appreciate relative to other forms of personal wealth. This avoided explicit "hard choices" about distribution and the rationing of credit by offsetting the losses to wages which followed the Volcker shock. In practice, targeting inflation means that the Federal Reserve and other central banks restrict credit at the point where labor markets begin to tighten. Until recently, central bankers assumed that inflation was at least in part triggered by an increase in employment beyond the Non-Accelerating Inflation Rate of Unemployment (NAIRU). This means that as an economy moves to full employment and workers can bargain for higher wages, central banks will restrict credit to engineer a pullback in the labor market.

As a result of these policies, a generation of homeowners found themselves with an appreciating capital asset, insured by the government, that could be used as a substitute for falling wages. New Deal housing policy was repurposed from the provision of long-term, stable shelter to a support for asset price inflation. This deal has been very good for a politically powerful cohort of homeowners who purchased their first house in the 1970s and 1980s. Coalitions of older homeowners have defended low taxes on housing relative to other assets and economic activities, such as California's infamous Proposition 13—

itself a reaction to the 1970s inflation. These same voters have made it impossible to build new housing units in high demand areas, jacking up prices on real estate. Housing wealth has become increasingly held by the old, white, and wealthy, while cohorts born after the 1970s have found housing a drag on their net worth. (Lisa Adkins and Martijn Konings argue that the political economy of the United States is now a machine for stealing the opportunity of the young to preserve the livelihoods of the elderly.) The deflationary coalition has been held together by a cohort of powerful voters whose financial position depends on the continual appreciation of capital assets at the expense of wages.

Minsky's 1983 prediction of a return to inflation did not come to pass in the United States nor in other advanced countries. The creation of deflationary coalitions around the world supported the shift from wages to capital gains. However, outside these economies, the world did in fact see a second round of inflation, concentrated in post-Communist economies. Soviet command economies which generated growth through investment in capital intensive producer goods experienced inflation not through the growth of prices, but through shortages and declining growth. Workers and managers avoided attempts at improving production due to a lack of rewards—a situation summed in the phrase, "they pretend to pay us, we pretend to work."

The liberalization and eventual collapse of Communist economies brought the problem of inflation into the open. To deal with these consequences, post-Communist regimes, including China, controlled the expansion of bank credit and the accumulation of foreign exchange through persistent trade surpluses. Mechanically, this was accomplished by lowering wages relative to productivity. Workers in these economies produced more than they could consume, creating a surplus that could be exported.

Michael Pettis and Matthew Klein have documented these arrangements in their recent book *Trade Wars are Class Wars*. In their study discussion of China, Pettis and Klein demonstrated that China's stabilization of its exchange rate in 1994 kept Chinese wages lower than productivity, allowing for the creation of a long-term trade surplus. And as Victor Shih has shown, this decision was part of a political push to stem inflation in the face of rising consumer demands and the previous decades' high investment into the country's Special Economic Zones. Recently, to sustain this set-up, Chinese authorities seem to be borrowing from the West and encouraging Chinese workers to invest in housing so as to avoid an increase in spending on non-durable goods and services that would threaten the export-driven model and bring back the specter of inflation.

Similar policies were pursued by Germany after unification. Due to the traumas of the 1920s, Germany has largely avoided the inflation that plagued other industrialized economies. A system of sectoral capital-management bargaining and aggressive anti-inflationary policy by the Bundesbank helped West Germany avoid the stagflation of the 1970s by aggressively holding down both the capital and labor shares. However, the same was not true for Communist East Germany. Many observers believed that German unification would necessitate inflationary consequences as the East German economy's repressed inflation would come into the open. However, German authorities instead fought inflation by virtually halting economic growth. In 1998, German authorities launched the Hartz Reforms to make the German economy competitive by lowering wages and pushing part-time work. Conveniently, this slashing of the labor share came at the same time as Germany entered the Euro, preventing poorer economies in southern Europe from protecting their domestic markets from a flood of German imports.

The surpluses of exporting countries were sustained at the expense of the American tradeable goods sector and its high paying jobs, thereby continuing to suppress inflation. In turn, however, exporters needed to purchase assets with their dollar-denominated receipts. The American financial sector was more than happy to provide them, financing the consumer credit that made the cycle possible. The demand for dollar assets in the mid-2000s helped fuel the American housing boom that ended in 2008. This cycle of funding and asset distribution connects “money manager capitalism” with “asset capitalism” and is the reason for its durability despite its financial instability.

Bringing inflation back

For some observers, a shocking result of the 2008 financial crisis was the “strange non-death of neoliberalism.” Why have neoliberal ideas persisted despite their apparent failures? The question seems less perplexing when we conceive of neoliberalism as a set of economic practices performed by institutions designed to protect the interests of the deflationary coalition.

Examining the current political landscape through the politics of inflation is illuminating: members of right wing populist movements, for example, are unified by a desire to preserve capital gains on asset ownership, whether they are CEOs of major banks or suburban homeowners needing to compensate for falling wages. The slogans of the Tea Party and the populist right in the United States against new spending clearly demonstrate this fear of inflation.

In the wake of the Covid-19 pandemic, the same fears are being raised to argue against government support to individuals to sustain public health measures. Instead, those who fueled the backlash against spending and a potential bailout of homeowners in 2008 are now pushing for a rapid reopening of the economy. In Europe, pro-austerity, right-wing coalitions have come into power to maintain the infamous “schwarze null”—the budget surplus so central to conservative politics in Germany and other Northern European surplus economies. Meanwhile, in China, authoritarian retrenchment is rooted in fear of the financial instability posed by the debts of local governments and the need to maintain the consumer repression of households.

In the period since 2008, and especially since the onset of the pandemic, visions of an alternative to the deflationary consensus have come from a surprising actor: independent central banks (ICBs). A cornerstone of the deflationary policy shift of the 1980s, ICBs are now uniquely positioned to fight for the growing portion of the population that has lost out from the system of asset price inflation, low wages, low goods inflation, and easy financing which has dominated policymaking in recent decades.

The European Central Bank and the Federal Reserve have begun to re-evaluate the legacy of prioritizing inflation targeting over full employment. So-called unconventional monetary policy is expanding the reach of the central banks into sectors outside the traditional banking system. After 2008, the Federal Reserve used swap agreements with foreign central banks to backstop offshore dollar credit and purchased the collateral of shadow banks outside the conventional banking system. In the past year, the Fed has entered corporate credit markets, thereby lending directly to the real economy, and has also taken halting steps toward lending to municipal governments and small businesses.

These experiments should be of great interest to those of us who want to see the creation of a wage-led growth economy. The ability of central banks to jump the barrier between the financial and real economies means that their power over the creation and limitation of credit can be used to “socialize finance”—as Minsky advocated for in his recovery of Keynes from the hydraulic Keynesians. Socializing the flow of investment in order to ensure broad prosperity will require institutionalization, perhaps separating the traditional function of central banks from a new kind of national or supranational investment authority designed to rationally distribute credit in ways that would neither be inflationary nor deflationary.

The control of the inflation-deflation cycle cannot be reduced to apolitical interventions in the supply of money. Rather, breaking this vicious cycle at the heart of capitalism will require us to understand how to best spend that money in a way on the appropriate capacities and goods for each phase of an evolving economic system. Establishing such an “investment rule” should be at the task of a post-deflationary economics. An activist central bank—striving to patch the problems that neoliberal deflationary politics have built—might be the path to achieving Hyman Minsky’s dream of stopping the boom and bust of inflation and deflation, through the socialization of finance.

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1. Hyman Minsky, "Global Consequences of Financial Deregulation" (1986). *Hyman P. Minsky Archive*. 378. ↩

Footnotes

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