There is no Wage-Price Spiral

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Discussions under the heading of a "cost of living crisis" deal with the plight of workers whose wages or benefits do not scale with inflation. Now, one could be forgiven for thinking that the concern must be that workers' livelihoods are being left behind as inflation soars. Yet, the opposite is true with commentators warning of a wage-price spiral where higher wages trigger further inflation, and thus are best avoided:

- "Boris Johnson warns of 'wage-price spiral' if workers demand higher pay" (The Guardian, 9 June 2022);
- "Bank of England needs to guard against a wage price spiral" (Evening Standard, 30 June 2022);
- "Can the UK avoid a wage-price spiral?" (The Financial Times, 1 February 2022).

1 The BoE explains inflation I: wages

Directly from the mouth of those tasked with controlling inflation, the Bank of England (BoE):

> "Governor Andrew Bailey said rising wage pressure threatened the BoE's ability to keep a grip on inflation, even as households faced the biggest calendar year squeeze on their incomes since at least 1990. 'I'm not saying nobody gets a pay rise, don't get me wrong, but I think, what I am saying, is we do need to see restraint in pay bargaining otherwise it will get out of control,' Bailey told BBC radio in an interview broadcast on Friday." — William Schomberg and Alistair Smout. *Bank of England calls for wage restraint to keep grip on inflation* in *Reuters*. 4 February 2022

The claimed relationship between wages and prices is false. It is perhaps easiest to start with an example. Say, Alice hires Bob to make widgets for her. She pays him £10 per widget, each widget requires £10 worth of raw materials and tools and Alice manages to sell those widgets for £30. After paying Bob and for raw materials, Alice is left with £10 to turn into cigars for her personal consumption. Now, assume Bob manages to convince Alice to pay him £15. Unless something else changes, Bob now goes home with £15 per widget and Alice with £5. The cigars previously enjoyed by Alice may now partially be enjoyed by Bob. We have no inflation and no increased purchasing power, but we witness a redistribution of wealth.1

Of course, Alice may try to increase the price of her widgets to £35 to recover her previous profits of £10 per widget. Yet, if Alice has the freedom to set the price of her widgets according to her personal profit appetite why did she not set it to £50, £100 or £200 to begin with? If employers could simply come up with the prices that match their profit preferences they would not have to keep wages (and other costs) down. Put differently, employers are not currently enduring strike action because they heed the BoE's warning that increased wages might lead to inflation, but to protect their bottom line. So, if Alice manages to increase the price per widget without shrinking the volume of widgets she sells then the explanation for this cannot be found simply in Bob's wage of £15.

But perhaps the economics work differently when we consider (essentially) *all* workers in society receiving a pay rise, arguably the scenario that the Bank of England is concerned about?

If, on the one hand, "widget" in the example above stands for commodities that are purchased by both workers and employers (either as employers or as private persons enjoying the spoils of their business) then the Alices of this world are confronted with a market situation where part of their clientele has more money (workers) and another part has less (other employers). Remember that Alice's attempted price increase is her reaction to reduced profits and here we assume that this is a situation faced by essentially all employers because it affects essentially all workers. Alice and her competitors can sell more to workers but have to sell less to fellow employers; ability-to-pay in total did not increase by the same argument as above: an increase in wages is a reduction in profits and vice versa.

If, on the other hand, "widget" in the example above stands for commodities that are only purchased by workers, then Alice's customers indeed have more money to spend. Thus, Alice could be successful in her endeavour to increase prices. Yet, the flip side still is that other employers have reduced spending power. The market for, say, tinned beans improves whereas the market for cigars and sports cars is in trouble. Alice, who per our assumption in this paragraph is in the business of making tinned beans, makes a tidy profit, but her fellow employers producing cigars do not. By the same logic as applied to inflation, prices for cigars would drop.

Therefore, it would not even imply inflation if Alice and her competitors were successful in establishing higher prices for widgets. Just because some commodity becomes more expensive does not mean money becomes less valuable. If the price of widgets increases that means, unless something else changes, there is less spending power available to purchase other commodities. If society has £100k to spend and now spends £35k instead of £30k on widgets, it only has £65k instead of £70k left over.

Finally, if the market of cigars is in trouble, other employers will switch their production to tinned beans instead of cigars, which pushes down the price of tinned beans. Spending in society is redistributed, but not increased.

It all comes back to this: Sellers cannot simply pick the prices that satisfy their profit appetite. For them to be able to realise increased prices others will need to have acquired increased ability to pay. Wage increases do not increase ability to pay in society, they simply redistribute it.2

2 The BoE explains inflation II: credit-financed business

Indeed, the Bank of England in its policy approach practically admits that it too does not buy its wage-price spiral explanation. In adjusting the "money supply", i.e. the interest rate of the BoE, the Bank acknowledges that it knows that inflation is a phenomenon related to the money it issues. That is, the Bank has one set of answers to the question "where does inflation come from" that it gives in its Governor's letters to the Chancellor. Here the "wage-price spiral" features next to a "strong demand" and "energy prices". A different answer is given in its monetary policy. In this case, the Bank of England's practical answer to the question of inflation is "supply and demand" for money:

> "The Bank of England has the job of setting monetary policy – the set of tools used to keep inflation low and stable. The main way we do that is through interest rates. An interest rate is the amount of money people get on any savings they have. It's also the charge they need to pay on their loans and mortgages. So what's the link between the interest rates and inflation? Higher interest rates make it more expensive for people to borrow money and encourage them to save. That means that overall, they will tend to spend less. If people on the whole spend less on goods and services, prices will tend to rise more slowly. That lowers the rate of inflation." — Bank of England. *What is inflation?* 3 February 2022

"to borrow money" – Let us consider the existence of these "people". The spending power available to most people does not derive from cheap credit, but from them selling something, typically their time to an employer. They must sell their ability to work to a business because they have necessities to pay for: rent, groceries, data plans, etc.

"encourage them to save" – A "cost of living crisis" is in public discourse because these necessities are, well, rather necessary. The question of saving more or less is not on people's minds but rather how to make ends meet. Faced with these problems it is rather fanciful to suggest that their choice to cash in on higher interest rates – a decision made by people dependent on wages and advised by the BoE to swallow a restriction in their living standards – is what brings down prices. The Bank of England can buddy up all it wants, what it describes here is not "people".

Instead, the Bank means businesses. But then the explanation needs to account for the fact that, apparently, the ability to pay of businesses comes about differently than that of most people. Businesses are not constrained in spending what they have earned but spend, routinely and on a large scale, with borrowed money. But the Bank does not even deal with businesses directly but with banks.

"The main way we do that is through interest rates. *An* interest rate is the amount of money people get on any savings they have." The Bank does not actually set *the* interest rates that people or businesses are charged or paid.3 These are set by financial institutions according to their own private calculations (based on general market conditions and in competition with each other). The Bank sets the interest rates that financial institutions pay when borrowing from (and receive when lending to) the Bank of England. This usually does affect the interest rates charged by private banks but to the BoE's frustration since 2013 this relation is anything but direct.4

In summary, this means that *somehow* – according to the Bank of England – the interest rate it charges and pays to private banks and the private credit operations of these banks with businesses affect the stability and value of the money that the Bank of England issues. Indeed, when businesses take their loans and invest, they produce commodities, i.e. the things they and their workers buy with money. Here, both sides come together: ability-to-pay not backed by previously earned income but backed instead by credit and also additional commodities being produced. Somehow this process is presently proceeding in a way that undermines the very thing that measures its success, i.e. measures profit: money. It does this to an extent that worries the Bank of England.5

On the one hand, this means that a discussion of inflation will need to have to start with central-bank-backed and credit-financed profit-making, not with wages.

On the other hand, this gives a hint as to why the Bank of England is so worried about wages. It knows of the relationship between wages and profits we based our argument on in the first part of this piece: higher wages reduce profits. It also knows that the profitability of businesses, their ability to turn (credit-backed) advances into surpluses, is what everything from the value of the money the Bank of England issues to the livelihood of everybody in society depends on.

The Bank of England does not warn of a "price-price spiral" nor does it warn businesses against increasing their prices. Those warnings are not given because the Bank understands the need for profit. This, in turn, is because the reproduction of society is made dependent on it. The advice to workers that they should restrict their own standard for these profit interests is telling about the place that these workers occupy in this economy; their standard of living is an obstacle rather than an aim.6

2.1 Footnotes

1 You might object that Alice saves part of her profits or reinvests them and that the effect of Bob's wage increase on that might drive inflation. Even assuming this were true, you would then have to talk about the lack-of-savings-price spiral or lack-of-investment-price spiral if saving or investment rates are the key datum that informs inflation.

2 We keep writing "ability to pay" rather than "money" to emphasise that it matters greatly *who* has money (when) and can thus spend it and not simply its total amount. This is in contrast to a common way of talking about inflation where some total aggregate of money is confronted with a total aggregate of commodities. However, the circulation of money and commodities is inherently intertwined and not a confrontation of two aggregates. For example, one £10 note can be used in 100 transactions in a day or in none.

3 The Bank explains this in e.g. Michael McLeay, Amar Radia and Ryland Thomas. *Bulletin 2014 Q1: Money creation in the modern economy*. 2014

4 See "Central Bank Policy since 2013" in *Economic Crisis (from 2007 to June 2020)*.

5 The Bank targets an inflation rate of 2%.

6 Beyond that observation, the question remains: how do businesses in credit-financed pursuit of profit produce inflation? This is the topic of another piece we hope to have out shortly.