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Inflation and distributive conflicts

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Abstract

In order to understand the rise and fall of inflation of 2022-2023, new theories and analytical frameworks are needed, closely connected the profound changes in monetary and fiscal policies that have accompanied the wave of price increases. This paper proposes a view of inflation as a set of distributive conflicts, develops a set of conceptual tools, reviews the recent empirical evidence and discusses policy responses.
The rise of inflation was set in motion by the production distortions that emerged at the end of the covid-19 pandemic and by major rises in energy prices, accelerated by the start of the Ukraine war. Price rises then spread throughtout the economy, due to business search for higher profits. Price levels are now stabilizing at a significantly higher level, with lasting consequences on income distribution, the purchasing power of wages, and financial values.
Facing inflation, economic policies have experienced a major turn, with monetary authorities in the United States and Europe turning to restrictive policies. The macroeconomic outlook, the trajectories of structural change, the distribution of income and the dynamics of finance are deeply affected by the new context; possible policy alternative, with a more coordinated framework for public action, are discussed in the conclusions of the paper.

Keywords

Inflation, income distribution, finance, economic policies

JEL codes

E31, E52, E61, E64

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Introduction

Between 2022 and 2023, inflation jumped and subsided in Western countries. In 2022, over the previous year, the consumer price index rose 8% in the United States and 8.4% in the Euro area. After peaking in the US at 9.1% in June 2022 and in Europe at 10.6% in October 2022, price rises have slowed down. In 2023 inflation is expected to be 4.1% in the US and 5.6% in the Euro area; in the last months of 2023 price raises have been below 3% (IMF, 2023).
This relatively short episode was set in motion by the production distortions that emerged at the end of the covid-19 pandemic and by major rises in energy prices, accelerated by the start of the Ukraine war. The spread of price rises throughtout the economy, however, was mainly profit-led, as business with some degree of market power raised prices in order to protect profits. Price levels are now stabilizing at a significantly higher level, with lasting consequences on income distribution, the purchasing power of wages, and financial values.
More importantly, economic policies have experienced a major turn. In order to address inflation, the monetary authorities in the Unicro
ted States and Europe - the Federal Reserve and the European Central Bank - have turned to a restrictive policy; interest rates, formerly close to zero, are now over 5% in the United States. Combined with a slowdown of the expansionary fiscal policies of previous years, in 2023-2024 the result is a reduction in economic growth; several Euro area countries are on the brink of a recession.
The consequences of inflation, and the effects of the changed policy approach in the US and Europe are important and could be long lasting. The macroeconomic outlook, the trajectories of structural change, the distribution of income and the dynamics of finance in advanced economies are likely to be shaped by the new context.
This article aims to offer the conceptual tools and a basic framework of economic analysis needed to understand what has happened with inflation, and what lies ahead.

1. Inflation and distributive conflicts

Inflation reflects the presence of tensions in the economy, on a national and international scale, and has to be understood starting from the distributive conflicts that characterize it - between countries, between economic actors, between sellers and buyers, between debtors and creditors, and between social classes.
The inflation we experience was initiated by price increases in gas, oil, and electricity and, internationally, represents a transfer of real income to energy-supplying countries. It is estimated that rising fossil fuel prices have led to the transfer of $1 trillion, about 1 % of world GDP, from importing countries to exporters of these goods (Bank of Italy, 2023, p.15).
Domestically, the transfer occurs from economic actors operating with unchanged prices and incomes to industries, businesses and social groups that can increase them. This redistribution process is determined by power asymmetries among economic actors and public policies that regulate energy prices, the functioning of markets and income redistribution.
Firms experience cost increases to which they can respond with increases in their prices; firms with market power can thus restore or increase profit margins. In the long run, firms can respond to inflation with investments, new products, processes, and organizational changes that lead to lower costs of energy, other imported inputs, or labor, or that increase the value of goods produced and exported, resulting in greater productivity and international competitiveness.
With inflation, consumers lose purchasing power and workers experience a reduction in real wages. The poorest households devote a larger share of their income to energy and food and are the most affected by increases in these prices. Self-employed workers may have some opportunity to increase the price of the services they provide, depending on their market power. Employees lose purchasing power and, in the absence of automatic adjustments of wages to prices, a recovery of real wages can only occur through the demands of collective bargaining agreements, which, however, are met with

strong resistance from businesses. In addition, a growing number of workers-including many temporary and part-time workers-are not covered by collective agreements and have little prospect of recovering their losses in real wages.
Trade union conflicts over the protection of real wages are the result of these dynamics. In this framework, uncertainty increases for all economic actors, with changes in patterns of consumption, saving, investment and expectations about the future.
For a country affected by inflation due to increases in imported energy, the terms of trade worsen (more exported quantities are needed to obtain the same unit of imported goods), there is a loss of competitiveness for companies that suffer an increase in internal costs, the current account balance of the balance of payments worsens. On the foreign exchange market, there can be a weakening of the national currency. Capital outflows may occur, in search of currencies and investments less threatened by the loss of value due to rising prices. This changes the hierarchy between economies.
Besides the impact on income flows, there are the effects on wealth and finance, which are particularly important in a model of capitalism marked by financial expansion. Since the 1980s, the rise of finance has been made possible by drastically reducing inflation through restrictive money supply and interest rate policies. As prices rise, holders of financial wealth face the erosion of the nominal value of bank deposits, shares and bonds; creditors are disadvantaged and debtors are favoured by the easing of the real value of past debts. With a restrictive monetary policy and high interest rates, interest earnings take on a new prominence, and new financial instruments can enable a resumption of portfolio investments. With inflation and high rates, the rules of the game of financial and real estate wealth accumulation change.
The dynamics of inflation, and its distributional outcomes, are conditioned by government policies. After thirty years of liberalisation, price controls and market regulations have not been used; monetary policy has become restrictive, with higher interest rates slowing down production, employment, wages and changing the structure of finance; fiscal policy has offered tax breaks and transfers to compensate households and businesses; energy, environmental and industrial policy has lagged behind, while it would have a key role to play in promoting the use of renewable energy sources and increasing productivity and sustainability of the economy. In Europe, and in Italy in particular, the policies implemented appear inadequate to address the problems that have emerged with inflation, as we will see at the end of this article.
In economies with national currencies, higher inflation tends to be reflected in exchange rate adjustments and currency depreciations that can have further far-reaching effects on a country's competitiveness and income distribution. In the case of euro area countries, monetary and exchange rate policies are centralised in the hands of the European Central Bank for economies with different rates of price increases, leading to further problems of potential policy misalignment.
The results of these processes are reflected in the changes in the world economy, and today's inflation appears to be primarily a Western phenomenon. According to estimates by the International Monetary Fund (data from the World economic outlook, April 2023), the increase in consumer prices in 2022 compared to the previous year - which exceeded 8% in the US and Europe - was 1.9% in China, 2.5% in Japan, 2.9% in Taiwan, 3.4% in Malaysia, 4.2% in Indonesia, 5.1% in South Korea. Other emerging countries recorded higher price increases, with 6.7% in India, 6.9% in South Africa, 6.6% in Morocco, 8.5% in Egypt, 7.9% in Mexico, 9.3% in Brazil. In some emerging countries, much higher inflation levels are part of deeper and longer-term economic crises; consumer price growth in 2022 was 72.3% in Turkey, 72.4% in Argentina, 49% in Iran.
The pressure on prices from post-pandemic production distortions, energy price hikes and profit chasing thus appear as a phenomenon that primarily affects the 'centre' of the world economy, the US and Europe. However, price increases tend to spread along international trade chains and, as in the past, the prices of high-tech industrial goods exported from the West tend to have a higher price dynamic than those of raw materials and intermediate goods exported from emerging countries; there is therefore a possibility that the negative effects of inflation will end up affecting even the more fragile economies of the Global South.

In fact, the inflation wave can also be interpreted as a reflection of the deeper upheaval in the world economy that is underway, with the rise of China and East Asia and the decline of the United States. In this perspective, the restrictive monetary policies launched by the US Federal Reserve could end up being a the new way to prolong the financial expansion model of the past forty years, redefining the terrain of international economic conflict.

2. Conflicting concepts, explanations and policies

A discussion of economic theories of inflation is beyond the scope of this article. We can refer to the two sides of mainstream approaches. On the one hand there is the monetarist view (Friedman, 1963, 1968) that considers price increases as an exclusively monetary phenomenon. The policy implications are that Central bank policies of liquidity reduction and interest rate increases can restore price stability.

On the other hand, there is the view of the neoclassical-Keynesian synthesis, based on the 'Phillips curve', the negative relationship linking unemployment and the inflation rate. This approach considers price increases as the result of excess demand in the goods market, which is transmitted to the labour market with a reduction in unemployment, resulting in rising wages, costs for businesses, and, therefore, prices. The policy implications suggest a need for restrictive monetary policies - with higher interest rates that discourage investment - and fiscal policies, with cuts in government spending; this reduces aggregate demand, creating higher unemployment that contains wages and thus costs for businesses. Facing lower market demand and lower labour costs, businesses stop prices from rising. The limitations of this approach for interpreting the economic facts of the last decades, when even with low unemployment inflation did not increase, were recognised by a study of the Federal Reserve (Ratner and Sim, 2022) and pointed out by more critical perspectives (Seccareccia and Matamoros Romero, 2022; Galbraith, 2023; Stiglitz and Regmi, 2023).

An alternative, more convincing perspective is the view of inflation as a distributive conflict, originated with the analysis of Michal Kalecki (1971) on the conflict between wages and profits in income distribution. In the 1930s, Kalecki developed, in parallel with Keynes, a model of the business cycle that focused on the role of aggregate demand. Growth, inflation and income distribution were explained by the investment decisions of capitalists, the oligopolistic power of enterprises in price setting and a Marxist view of class conflict.[1]

This approach was developed in the 1970s by several streams of research, including the work of Bob Rowthorn (1977) on the UK and Europe, and the studies of Graziani (1975) and Vianello (1975) on the Italian economy.[2] From the 1960s to the 1980s a key policy question in high-inflation countries was the indexation of wages to prices; this automatic mechanism became the main instrument to protect real incomes and to strengthen the positions of workers.

In the 1980s, policies had to combine the challenge to reduce inflation with the impact on growth trajectories and income distribution, as "the inflationary process is one of the means by which the economy reconciles a certain distribution of income with the desired growth rate" (Ciccarone and

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[1] A seminal article by Kalecki is 'Political aspects of full employment' (Kalecki, 1943) in which he argues that an expansionary policy leading to full employment is hindered by the 'captains of industry' because 'discipline in the factories and political stability are more important to capitalists than current profits'.

[2] For Vianello, inflation was one of the “profit recovery mechanisms” in parallel with the abandonment of fixed exchange rates and the decentralisation of production outside large firms. These were business responses to the “increased rigidity of the workforce in large and medium-sized factories and to the greater independence of workers' struggles from the economic cycle” (Vianello, 1975, p.119). For an analysis of inflation in Italy see Graziani (1998), Vicarelli (1987), Cucignatto et al. (2023).

Gnesutta, 1993, p.158)[3]. With changing power relations between capital and labour, and a serious weakening of trade union strength in the US and Europe, the break-up of wage indexation mechanisms was a major step taken in several countries, leading to losses in real wages and a clear shift in income distribution. The result is that between 1980 and 2020, in most Western countries, the labour share in national income has fallen by ten to fifteen percentage points (Franzini and Pianta, 2016).

The difficult balance between expansive monetary and fiscal policies to support growth and restrictive policies to contain inflation marked the 1960s and 1970s against a backdrop of increasing instability. In the case of the United States, according to Hyman Minsky, "what the Federal Reserve and the Treasury do to contain crises leads to inflation, and what they do to restrain inflation leads to financial crises and threats of deep depressions" (Minsky, 1984, p.9). In this way, "both the Great Depression and the intermittent inflation and stagnation of 1966-79 are symptoms of the underlying instability of capitalism. A Great Depression is the result when the public sector is limited and the central bank is timid. A great stagflation is the result when the public sector is large and the central bank intervenes vigorously' (id., p.129).

Inflation emerges when expansionary policies facilitate the rebuilding of profits, even after inappropriate investment choices, with the effect of easing debt repayment burdens. According to Minsky, it is a reflection of the underlying instability of capitalism, aggravated by the speculative logic of finance, which is bound to create new possibilities for crises like that of 1929.

Minsky's (1984) fundamental contribution is in identifying the possibility of a sudden financial collapse after a strong financial expansion under conditions of high debt and instability - what is called a 'Minsky moment'. The financial crisis of 2008 led to an acknowledgement of these insights even by mainstream economics, which had long described the post-1980 financial expansion as a period of 'great moderation' and even the 'end of business cycles'.

The great financial crisis of 2008 shook this house of cards. It made clear the risk of a general collapse of financial values and a severe recession (Tooze, 2020). The US policy response was immediate, with a huge expansionary policy. Monetary policy injected liquidity into the system, refinancing banks and financial players to prevent a sell-off and support financial values. Fiscal policy increased spending to support demand and avoid a recession. The recovery of the US economy and finance was relatively swift, but with a profound change in the role of monetary policy, which became the engine that ensured liquidity in the system, offering financial operators money at negative real interest rates and buying securities - public and private, including ‘deteriorated’ assets - with the large Quantitative Easing programme.

It should be remembered that in Europe the initial response was the opposite, with the European Central Bank raising interest rates and Brussels imposing austerity policies, leading to a decade of crisis and depression in many Eurozone countries. Only with much delay did the ECB reduce interest rates and switched to Quantitative Easing measures, and only with the arrival of the pandemic recession in 2020 did European fiscal policy actually become expansionary. The lesson of these fifteen years is that, when faced with unstable situations, policies are crucial. And behind the decisions of governments and central banks there are - equally decisive - different ideas on how to make the economy work.

In the United States, the mainstream view of inflation has been restated by Bolhuis, Cramer and Summers (2022), pointing at excess demand as a key cause of rising prices. In particular, key factors include the over-expansionary fiscal policies implemented by Joseph Biden's presidency to deal with

[3] In EU countries, the exchange rate agreements called for the reduction of inflation, achieved through highly restrictive monetary policies with high interest rates pressing down on profits. The result is that "as far as wages in real terms are concerned, they have to fall either directly, to make room for the higher profits demanded, or indirectly, through increases in the cost of living (with wages now non-indexed)" (Ciccarone and Gnesutta, 1993, p.159).

the covid-19 pandemic recession; the overly generous household subsidies; the tight a labour market with a fall in labour force participation, and a rise in employment and wages. The 'cure' that has been proposed is a return to restrictive monetary policies, reversing a decade of Quantitative Easing that had brought interest rates to around zero. Monetary restriction reduces credit for investment and household consumption, depresses demand and the economy's growth to the point of possible recession.[4]

This has been the path chosen by US authorities, with the turnaround decided by the Federal Reserve in the aftermath of the Russian invasion of Ukraine and followed in mid-2022 by similar measures by the European Central Bank. In May 2023, the interest rate in the US was thus raised above 5% and that in the Eurozone to 3.75%.

This policy aims to bring inflation back to the target the central bankers have set themselves: 2%. From the mid-1980s to the surge of 2021, in fact, US inflation was not far from that 2%, rarely exceeding 4%. Such low inflation for almost forty years created the conditions for financial expansion, protecting financial values from the risks of losses in real terms. However, this policy led to a trajectory of low income and employment growth, particularly severe in Europe, where it was coupled with austerity fiscal policies. Even when monetary policy took a more expansive path, with Quantitative Easing, the 2% inflation target remained unchanged, thus limiting the scope for a recovery in the real economy.

A criticism of this traditional view of the priority given to containing inflation came in 2010 from the then chief economist of the International Monetary Fund, Olivier Blanchard; he proposed an inflation target of 4% (Blanchard et al. 2010) to avoid the risk of stagnation following the 2008 financial crisis. Facing current inflation, Blanchard corrected his assessment, proposing a target of 3% (Blanchard, 2022). Other experts concurred. According to Stiglitz and Regmi "it would be desirable, perhaps even necessary, for the 2% inflation target to be revised, at least temporarily" (Stiglitz and Regmi, 2023, p.372). In June 2023, Paul Krugman (2023) also argued that raising the inflation target to 3% would be appropriate. Neither the US Federal Reserve nor the European Central Bank have taken up these suggestions and the fight against inflation remains the pole star of monetary policy on both sides of the Atlantic.

Relaxing the inflation target - e.g. keeping it below 4% over the next few years - would avoid a recession caused by overly restrictive policies, would provide room for growth in the economy and employment and for the necessary structural adjustments. A more relaxed inflation target would bring US and European monetary policy back into a more coherent economic policy framework.

The traditional approach of monetary policy as a tool to fight inflation is particularly inappropriate in the face of today's inflation driven by energy prices and supply distortions during the post-pandemic recovery; conversely, restrictive policies and high interest rates make the transition to an economy with lower energy vulnerability and higher productivity more costly and difficult.

Along these lines, in the case of the United States, an important explanation for current inflation has been developed by studies focusing on supply-side changes (Weber et al., 2022; Weber and Wasner, 2023). An impulse-propagation-conflict model has been proposed, that focuses on bottlenecks in the supply of certain production inputs in emergency contexts such as the pandemic first, and the rise in the price of energy goods later. Attention is given also to the greater industrial concentration and the increased market power of firms in many sectors, and to the price increase strategies that have been implemented by major firms. The result has been an increase in the share of profits, after tax, in relation to value added, which has reached the highest levels since the 1950s. A study that updated the data set shows that profits per unit of value added for US non-financial firms in the second quarter of 2022 reached 16.5%, compared to 11.6% in the first quarter of 2020 (Ferguson and Storm, 2023, p.12).

[4] On the US debate on inflation see Galbraith (2023), Stiglitz e Regmi (2023), Ferguson e Storm (2023).

If inflation has such origins, a restrictive monetary policy has little effect on prices; on the contrary, it weakens small enterprises and can strengthen the oligopolistic power of the large corporations that are the protagonists of price increases. By increasing unemployment and squeezing wages, it can further strengthen corporate profit margins. The most effective policies against this type of 'seller' inflation are forms of price controls, the creation of reserves for strategic commodities such as energy goods, limits on financial speculation in commodity markets and the introduction of taxes on super-profits obtained in this way (Weber and Wasner, 2023, p.208). Such supply-side factors, rising energy prices and profit growth are even more relevant for European economies.

3. Inflation and the economic system: digital technologies and globalisation

Alongside national macroeconomic dynamics, some 'systemic' dimensions must be considered, concerning the 'drivers' of price changes and the transformations of capitalism over the last forty years.

Since the 1980s, capitalism has been characterised by the emergence of the new digital technology paradigm; by processes of globalisation of production; and by a phase of expansion dominated by finance. All these processes have an impact on price dynamics and on the distributional conflicts associated with them. All these processes are part of the neoliberal model that has defined the new characteristics of the economic system, with new modes of accumulation processes, the expansion of the market sphere, greater power of capital over labour, an increase in inequalities, and the downsizing of public action.[5]

Let us first ezamine how digital technologies and globalisation have led to a containment of price dynamics.

Digital technologies. In the 1980s, the new 'technological paradigm' of information and communication technologies emerged, which gradually replaced the previous 'Fordist' paradigm based on the mechanical and electrical technologies of industry-based mass production. A new paradigm entails profound transformations in knowledge, innovations, goods and services produced, consumption patterns and the prices of these activities. The technologies of the new paradigm - chips, computers, telecommunications, software applications, data, etc. - are characterised by rapidly decreasing prices, increasing performance and a vast range of applications, which makes them pervasive throughout the economy (Freeman and Louça, 2001; Dosi, 1982).

An OECD study calculated that between 2005 and 2015, changes produced by digital technologies affected one third of the goods in the household consumption basket. If we take into account the effects of falling prices, improvements in quality and variety, it can be calculated that these factors reduced the consumer price index by 0.5% per year (Reinsdorf and Schreyer, 2019).

The offer of free digital services (from e-mail, to social media, to access to texts and videos) has increased the availability of goods of individual users for the same income, even if the ways in which costs are covered - from the collection of personal data to the involvement of the user in the production of the service, from targeted advertising to the conditioning of consumption behaviour - make the 'free' nature of the service appear illusory.

Globalisation. Since the 1990s, the globalisation of production has led to a sharp increase in global trade, the involvement of national economies in global value chains, a fall in tariff barriers, and increased international competition, all of which have contributed to lower consumer price dynamics. An OECD study showed that for the G7 countries between 1982 and 2003, import prices remained essentially stable, while domestic producer prices rose by 30% over that period. The increase in

[5] According to David Harvey, we can interpret neoliberalism "as a political project to re-establish the conditions of capital accumulation and restore the power of economic elites" (Harvey, 2005, p.19).

import shares further diffused the price-containing effects in the economy. With a few exceptions, commodity prices rose less than the prices of industrial goods, favouring the more advanced countries. Considering imports from China alone, between 1996 and 2005, it was estimated that they had the effect of reducing inflation by an average of 0.1% per year in the US and 0.3% in Europe. The overall impact of globalisation is estimated to have been a drop in consumer prices of between 0 and 0.25% per year since 2000 for all OECD economies (Pain et al., 2008). [6]
Overall, in the past decades when inflation in the US and Europe has fluctuated around 2% per year, digital technologies and globalisation may have contributed to price reductions of around 1% per year. Thus, a space was created for domestic producers' prices and profits to rise.

4. Inflation and financial expansion

A central point for understanding the issue of inflation is the nature of the economic model that has characterised the 'centre' of the world economy - the United States, Europe, Japan and other richest countries. Since the 1980s, capitalism has shifted from a phase of material expansion - which had characterised industrial mass production in the years of 'Fordism' - to a phase of financial accumulation. The increase in asset values was a main driver of this process.
The increase in the price of an asset - shares, bonds or real estate - can result from real improvements - a company investing and innovating, or a renovated property - or from a run-up in asset prices due to speculative behaviour: buying today to resell tomorrow at a higher price. In these cases, price increases do not correspond to real improvements, and we could think of this process as an 'asset price inflation'.
Such increases in asset values create opportunities for rent-seeking and speculative gains, often to the detriment of the long-term prospects of the real economy, opening up the possibility of speculative 'bubbles' that can lead to financial crises, as in 2008. Such behaviour has characterised the strategies of many large companies in the US and Europe. Following the objective of maximising 'shareholders' value', priority has been given to increasing their stock price, achieved by distributing high dividends to shareholders, or by repurchasing their own shares as a means of increasing demand and share price, while at the same time reducing investment and spending on research and development as the basis for long-term growth (Lazonick, 2014).
Increasing the value of shares has become so important that some of the fastest growing companies, especially in the digital sector - Alphabeth-Google and Netflix for example - do not distribute dividends and do not look at profits as the most important variable; their goal is the expansion of their stock market value, reflecting their growth in size, entry into new businesses and the acquisition of competitors, strategies that are often financed with high debt. The growth in stock market prices thus corresponds to an expansion in the real assets of companies, but expectations of growth can feed a speculative logic that inflates stock values abnormally.
It is difficult to measure the dimensions of such a financial inflation, but the growth of values on the New York Stock Exchange, the centre of these phenomena, is a relevant indicator. One of the most widely used stock market indices is the Dow Jones Industrial Average, which records the share prices of an average of the 30 largest US companies in all sectors.[7] It is a partial indicator - given the variety of other financial assets that exist - but closely reflects the price dynamics of financial assets. The index has boomed from a value of 3200 in 1980 to a value of 33000 in May 2023, a tenfold increase. Taking into account the growth of the US economy, we can calculate the ratio of the Dow Jones index

[6] Similar conclusions are found in a ECB study (Attinasi e Balatti, 2021).

[7] Among the companies considered are Apple, Boeing, IBM, JPMorgan Chase, Goldman Sachs, McDonald's, Microsoft, Nike, Walmart. The other index of the New York Stock Exchange, the Standard & Poor 500, considers a broader and more diversified group of 500 companies and records a cyclical trend similar to that of the Dow Jones.

to the US GDP, measured in billions of dollars at current prices; in this case, the ratio went from 0.3 in 1979 to 1.5 in 2022, multiplying by five.[8]
Another measure of the size of finance is offered by stock market capitalisation (prices multiplied by the number of shares, with data from the World Bank) and here for the New York Stock Exchange the values, in relation to US GDP, rise from 47.6% in 1980 to 193% in 2020. In other words, the total value of all companies listed on the New York Stock Exchange has risen from half to almost double the GDP, a fourfold increase. Data are also available for the capitalisation of all stock exchanges in the world in relation to the world's GDP, and here we go from a value of 29.5% in 1980 to a ratio of 133% in 2020, a multiplication of four and a half times.[9]
Such an expansion of share prices and stock market capitalisation is not based on the real size of the listed companies, nor does it correspond to the growth of the economy; there is an obvious speculative dimension, which led to the crises of 2001 and 2008, when the falls in stock market prices, however, were only brief pauses in a continuously growing trend.
An attempt to incorporate financial expansion into US economic accounting suggests that rising stock, bond and real estate prices are now the main source of wealth growth, replacing the role of profits and savings. These capital gains are realised on investments financed with more private debt, facilitated by easier access to credit in the context of expansionary monetary policies (Hudson, 2021). The increase in asset values is driven by increases in the prices of financial and real estate assets, relative to a slowly growing real economy. These increases are not reflected in the consumer price index - the measure generally used to quantify inflation - but have major effects on relative prices and income distribution. There are important consequences on the relations between 'industrial' and financial capital, and on those between capital and labour.
Productive investment, which expands economic activities and creates employment, offers lower returns and higher risks than financial investment, which aims at rents and capital gains. The logic of finance prevails over the logic of production; in the internal distributive conflict between industrial profits and financial rents, it is the latter that prevails and dictates the trajectories of the economy. The result has been stagnating investment in the United States and Europe, which has contributed to the slowdown in GDP growth and employment. In addition, manufacturing companies themselves are being pushed down the path of financialisation, for example with the strategy of increasing their stock market prices, in some cases limiting their commitment to research, innovation and investment in production capacity.
Capital-labour relations and economic inequalities are also strongly influenced by the expansion of finance. As argued in our book on inequality (Franzini and Pianta, 2016): "financial assets generate rents that reduce the profits flowing to productive capital and labour compensation. The accumulation of financial and real estate wealth feeds mainly on the inflation of asset values and speculative bubbles; this can have an indirect impact on GDP dynamics through the wealth effect (those who feel richer due to the increase in the value of their assets consume more), but at the cost of greater instability and the risk of financial crises" (id., p.112). In distributive terms, inequality increases due to the falling share of labour income and the distribution of profits and financial rents mainly to the richest 10% of the population, with a further strong concentration in the 'super-rich' 1%. Finance thus becomes one of the 'engines' of the increase in inequality, within a more general increase in the power of capital over labour, a phenomenon that modifies social relations, drives back the dynamics of real wages, weakens trade union protections and social rights, and reflects changes in the distributive conflict between social classes (id., ch. 4).

[8] Data from Macrotrends.net, https://www.macrotrends.net/1319/dow-jones-100-year-historical-chart; https://www.macrotrends.net/2574/dow-to-gdp-ratio-chart.
[9] The source is the World Bank's interactive database; for the United States: https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?name_desc=true&locations=US; for world data it is https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS

More recent studies on the distributive effects of financial expansion in the case of the US have shown that the benefits are concentrated in the hands of the wealthiest and fuel inequality (Taylor, 2020). In the Eurozone countries, the distributive effects of financial asset inflation were examined using data from the Household Finance and Consumption Survey, showing that the increase in stock values was concentrated in the hands of the 5% of Europeans with the greatest wealth; higher stock prices went to the richest 25%, while increases in real estate values mainly benefited the middle segment of the income distribution (Adam and Tzamourani, 2016).

Finance and the economic system. The expansion of finance and the inflation of asset values thus represent a fundamental element of contemporary capitalism. The underlying mechanisms have been reconstructed in the monumental economic history of the United States by Jonathan Levy (2021), who devotes a major attention to the dynamics of finance: today, "the increase in the financial value of assets - through their sale (capital gains) or the possibility of using them as collateral to obtain credit (leverage) - is at the origin of monetary income. Income growth has thus shifted from labour to owners, or those who own assets with rising prices. As a result, income inequality increased (Levy, 2021, p.589).

The history of this financial transformation of US capitalism began in the late 1970s, during the years of high inflation, which peaked in 1980 at 13.5%. According to Levy: "inflation is not always bad. A little inflation can reduce rentier profits, encourage current spending, fuel expectations of future profits, and discourage the accumulation of cash and highly liquid assets. But persistent, volatile and high inflation can destabilise expectations and (...) threaten long-term development (...). To end inflation, an authority must arbitrate discord, decide on distributional conflicts between sectors and economic groups, and redesign a viable long-term trajectory for the economy' (id., p.550).

In the crisis of the late 1970s, with Ronald Reagan's victory in the 1980 presidential election, this authority was exercised mainly by Paul Volcker's Federal Reserve, which inaugurated a policy of sharp increases in interest rates and restriction of the monetary base. The result was a deep recession, which spread throughout the world economy, and a sharp rise in dollar prices. "Following the Volcker shock, much of the world economy remained depressed in the 1980s, with financial capital flowing into the US. Thus the new capitalism was born in the US" (id., p. 590).

The basic features of financial capitalism are the elimination of inflation - a necessary condition for the expansion of finance - and the placing of the US at the centre of world capital flows. The price increase in the US, after reaching 13.5% in 1980, fell rapidly as a result of restrictive policies: it fell below 2% in 1986, and then fluctuated between 1% and 3% for most of the period up to 2020, with few exceptions.

High interest rates, the rising dollar, and policies to liberalise international capital movements caused capital from all over the world to flow into the United States in search of high financial returns and asset price appreciation, with the Federal Reserve as the lender of last resort, providing the liquidity needed to trade in the financial markets.

Levy calls this model of financial expansion in American capitalism the 'Age of Chaos' (id., ch. 19-22), marked by international instability, new financial crises, weakening of the real economy, worsening social problems, and growing inequality: “This is not a capitalism that works in the interests of a large proportion of American citizens, whose incomes do not depend on the increase in the financial value of assets” (id. p.738).

A powerful formulation of the role of financial expansion in today's capitalism has come from Giovanni Arrighi (1984). The development of capitalism is interpreted as a sequence of accumulation cycles, characterised by a first phase of material growth and a second phase of financial expansion. In parallel, there is a succession of hegemonic cycles in the political relations between states; the hegemonic country represents, in each period, the centre of the world system.

Growth in the first phase of the cycle is rooted in technological progress, the emergence of new production sectors and high demand for new products, with a rapid increase in production and trade. Capital invested in production initially earns large oligopolistic profits, which attract new capital into

the same activities, increasing competition and reducing the rate of profit. Together with rising wages and conflicts between capital and labour, this process leads to a crisis, a recession due to inadequate profits. The response to the crisis opens up the financial expansion phase; capital is invested in more liquid forms and aims for higher returns through increased financial values. Financial expansion produces a period of renewed growth, but capital accumulation cannot be sustained indefinitely through financial investments and speculative bubbles.
This has been the case since 1980, with the financial crisis of 2008 being a sign of the instability of this model. The high levels of financial values, the weight of private and public debt, the episodes of bank failures, the growing uncertainty, and the return of inflation and restrictive policies, raise the possibility of an exhaustion of financial expansion.

5. Rethinking economic policies in times of inflation

In this analysis we have repeatedly emphasised the central role that economic policies have played in the evolution of inflation, and the contrasts that exist between conflicting objectives. In this context, the importance of a coordinated approach to economic policy must be emphasised. A coherent set of actions in the different policy areas would be crucial in order to avoid the risks of new crises, falling real wages, recession and instability. A possibile set of more integrated policy directions is outlined below.

Wage policy and income distribution. The rise in inflation in 2022 was not accompanied by debates on its distributive effects and on how real wages could be protected. These issues had been at the centre of the policies addressing inflation in the post-war period, and in the 1970s. With weaker trade unions and the fragmentation of labour, today's policy appears to take it for granted that the effect of inflation must be an impoverishment of labour income, and that the only possible action is some modest compensatory transfer for the poorest social groups. Moreover, the combination of restrictive monetary and fiscal policies appears to be designed to prevent any possibility of wage recovery, for fear of a run-up between corporate prices and workers' incomes.
In the current context, it is difficult to imagine a return to income policy as an important area of public action. Some specific measures, however, could contain the fall in real wages.
On the level of industrial relations and the resulting income distribution, the most immediate need is the renewal of collective labour agreements, where trade unions and companies can negotiate nominal wage increases. Public support to business in the face of rising energy prices could be made conditional on good labour practices, wage increases, reductions in fixed-term and part-time contracts, improvements in the quality of work. A key measure in this area is the introduction of a minimum wage indexed to the cost of living, representing a minimum safety net in the face of a fall in the real value of lower wages.

Monetary policy. We have seen that, in the face of inflation, in 2022 the monetary policy of the Federal Reserve and the European Central Bank has taken the path of raising interest rates and restrictive measures, with the aim of bringing inflation below 2% per year. The effects are an economic slowdown, lower employment, financial risks, and bank failures.
An alternative could be changing the inflation target to 4% for the next few years, and have modest real interest rates – as we have argued above – thus avoiding monetary tightening and recession. The underlying objective of monetary policy could include the gradual retrenchment of financial values, avoiding a sudden collapse. Along this path, inflation close to 4% would reduce financial expansion and the real value of private and public debt. Low interest rates could favour investment in the real economy over financial investment and facilitate the achievement of the objectives of the other policies discussed here. In Europe there would be a need for close coordination between the monetary policy choices, made in Frankfurt by the European Central Bank, and the fiscal policy framework established in Brussels and national policies.

Fiscal policy. In the US, and even more so in Europe, fiscal policy is moving out of the expansionary measures that have made the post-covid-19 recovery possible. In the Euro area, the suspension of the spending constraints of the Stability and Growth Pact - introduced during the pandemic crisis - will be replaced in 2024 by new rules pushing national governments on a public debt reduction path that will require significant budget surpluses. Such new restrictive orientation of fiscal policy could aggravate the slow down of the economy.
A sensible alternative could aim at maintaining the space for expansionary fiscal policies at the national - as well as at the EU - levels, enabled by a monetary policy such as the one described above. During the pandemic and the energy crises, increased public expenditures have mainly gone to generalised subsidies to business and households. Public funds failed to finance a revival of welfare systems and public services, nor did they contribute to the large scale investment needed for the ecological transition and renewable energy sources. Such social and environmental priorities are more important than increased military spending, and have more pervasive economic effects (Greenpeace, 2023).
With a less restrictive monetary policy, public budgets could benefit from lower interest payments on public debt and from a reduction in the real value of debt; the debt/GDP ratio could also decline as a result of higher economic growth. In Europe, a common fiscal policy, building on the experience of the Next Generation EU programme, financed with collective EU public debt could be an important step in the direction of a more effective economic policy (Quadrio Curzio, 2017; 2022).

Energy and environmental policy. In the face of rising energy prices in 2022, most European governments have cut taxes on energy goods and offered compensatory measures for households and businesses; possible (and ineffective) forms of taxation of the extra-profits of companies in the energy sector have also been considered. In some countries, however, gas and electricity prices have been capped, new market rules have been introduced, and energy companies have been nationalised, abandoning the logic of market liberalisation, with the result of limiting the transmission of inflation to the rest of the economy. In fact, price controls and actions of this type are much more appropriate and effective in containing price surges in particular areas of the economy (Galbraith, 1980; Galbraith, 2023; Weber and Wasner, 2023). A wider challenge for policy is that of reducing the energy intensity of productions and move to environmental unsustainability; such a change in the growth model would reduce national vulnerability to increases in imported energy prices and to the negative effects of climate change.

Industrial policy. Long-term responses to inflation require transformations in the structure of the economy. Technologies, productions, employment, and business organisations should shift towards activities that are more knowledge-intensive, have higher productivity, higher-quality labour and are environmentally sustainable. A change of this kind requires an industrial policy that designs a different trajectory for the economy, coordinating public actions and business investment strategies in view of developing new areas of appropriate economic activities. Efforts for organising new markets and consumption models would be needed, with distribution patterns that reverse the increase in inequalities. The policy space for such actions has now emerged both in the US, with the large funds of the Inflation Reduction Act of 2022 (Kuttner, 2023), and in Europe with the plans for a European Green Deal (Pianta et al., 2020; Pianta et al. 2020). Steps towards a new growth model, however, would require an expansive monetary and fiscal policy framework, in order to make public funds and private investment available.
Again, the need for a more coherent policy approach emerges, in contrast with the fragmented, ad-hoc policy actions that have characterised Western responses to price increases. Starting from an exploration of the drivers of inflation, we have identified key structural problems of our growth model: energy dependence and environmental unsustainability; unequal income distribution and inadequate real wages; financial instability and the risk of further crises.

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