How would Friedrich Hayek Explain the Causes of Today's High Inflation?

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Inflation and unemployment are frequently referred to as the "twin evils" of macroeconomics, but inflation is rarely given the attention it deserves by politicians and central bankers. It is the unappreciated cause of the decline of regimes throughout history, from the Roman empire to the German Weimar Republic to modern Venezuela. Inflation is the rate of increase in prices over a given period of time; it is caused either by increasing material costs, such as wages and raw materials, or by an expansion in the aggregate demand for products. In the past, when currency was based on silver or gold, inflation could only occur as quickly as those metals were mined. Today, however, every country uses fiat money, which is inconvertible paper money made usable by edict of the government; this allows governments to easily control the money supply, which often encourages inflation. Canada's inflation rate over the past 30 years has nevertheless been remarkably stable; in the three decades before 2020, inflation averaged at under 2% annually, the widely accepted target rate (Statistics Canada). These decades of low inflation came to an end in 2021, due to policies designed to address the Covid-19 pandemic. As contemporary analysts continue to debate the economic response, it may be useful to return to one of the late experts on the subject; the Nobel-prize winning economist Friedrich Hayek, who greatly contributed to the field of economics through his work on monetary theory and business cycles.

When Covid-19 struck Canada's economy along with the rest of the world, leaders were forced to react. A supply shock, partially caused by public health restrictions, caused the GDP to contract and unemployment to rise. This alarmed governments, and prompted a drastic response that ensured a relatively short recession. The Bank of Canada injected hundreds of billions of dollars in liquidity, mostly through the Government of Canada Bond Purchase program, in which the BOC spent hundreds of billions of dollars buying government bonds on the secondary market. By April 2021, the BOC was purchasing Canadian government bonds at a weekly pace of $4bn, reaching a total of $575bn worth of bond assets on its balance sheet (Macklem et. al 23-24). This practice, used before during the Great Recession, is known as quantitative easing. The federal government itself spent hundreds of billions in fiscal stimulus. As of July 3, 2020, the government of Canada had spent $403bn on its pandemic response, with over half going directly towards individuals and businesses ("Economic Response Plan"). The true costs were only visible after the economy reopened; inflation in 2022 averaged out at nearly seven percent, over three times the target rate. Canada experienced a total inflation rate of 15% from 2020 to 2023, more than the previous eight years ("Consumer Price Index").

Although he died 31 years ago, Friedrich Hayek laid out theories that explained government actions and the resulting inflation. In his 1960 work *The Constitution Of Liberty,* Hayek argued that inflation is primarily caused by an expansion of the money supply that outpaces the growth in the economy's production of goods and services (451). When the money supply increases faster than the availability of goods and services, the relative scarcity of money decreases, leading to rising prices. Hayek emphasized the potential consequences of inflation on resource allocation. The massive government spending undertaken during the pandemic might result in misallocations of capital and resources. As businesses and individuals respond to distorted price signals caused by the influx of money, investments may be directed toward sectors that are not economically viable in the long run (458). One of the consequences of inflation he described is economic uncertainty; entrepreneurs and investors struggle to make accurate calculations and allocate resources efficiently, and employees become anxious that their wages are declining in value and demand raises (465). Finally, Hayek believed that inflation isn't an issue that can solve itself, and that the longer it is allowed to go on, the more difficult it is to end it; when inflation is allowed to continue, rising price levels increase the need for welfare state measures, which in turn increase inflation (455).

Hayek's views on the causes and effects of inflation are still able to explain the inflation caused by the excess monetary response to the Covid-19 pandemic. Liquidity injected from 2020 to 2021 was the main source of the inflation that mostly started in late 2021 and still persists to this day. In the past year, governments have largely realized the effects of their policies, and tried to remedy it by raising interest rates from nearly zero to 4.5% in the case of Canada and 5.25% in the US. Hayek's warnings about distorted price signals were shown to be true in the case of several major US banks, which leant out money at low rates during the pandemic only to find that after the rates were increased, their liability on deposits was greater than their assets of government bonds and loans. As of May 2023, 186 banks were at risk of collapse (Cohan). Hayek's belief in the inability of central planners proved correct as well; it was only in late 2022 that the government admitted that it had mismanaged the crisis in many ways, with 27.4% of the money being given to ineligible persons (Clemens et. al 1). The Bank of Canada also admitted to inaccurately responding, as it kept the interest rate at only 0.25% for several crucial months when it should have been raised. To prevent inflation from spiraling out of control, the BOC was forced to raise interest rates again to the highest since 2007. In addition to a rise in price levels, the inflation caused widespread anxiety amongst workers, which manifested in a higher frequency of strikes, the most notable being the 2023 federal worker strike. A recent example of inflation being used to cure its own symptoms came in May of 2023, when the government of Canada introduced a $2.5 billion bill to help Canadians deal with higher grocery prices.

While the Bank of Canada continues to fight inflation through quantitative tightening and interest hikes, it's not too early to consider ways to avoid such situations in the future. Hayek advocated for a monetary system that minimizes discretionary intervention by central banks. He argued for a return to a more rule-based approach, such as a fixed or predictable money supply, to promote stability and discourage inflationary practices. A stable growth in the money supply would allow market forces to operate freely and facilitate efficient resource allocation. The accuracy of Hayek's predictions decades after his death prove that even in times of crisis, governments must always be wary of provoking inflation.

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