The Repo Market and Conflict Inflation

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Abstract

This article seeks to connect today's inflation with one of the least studied and understood creations of the Federal Reserve - the repurchase (repo) market. Despite decades of existence, it is only in the last few years that the repo market has ceased to function smoothly, experiencing first a moment of crisis followed by one of great profitability. When functioning properly, the repo market went virtually unnoticed. Now that it is not, the market has gained the attention of mainstream economics as well as policy makers. However, conventional academic analysis is limited and cannot fully capture the effects that the repo market has had on the overall economy. In this article, we argue that the causes of the pandemic inflation and its public policy response can be understood as the culmination of the longer term currents of globalized financialization and central bank independence. To sharpen our focus on the shorter term, we construct upon the heterodox position of conflict inflation, and argue that the repo market and its principle actors should be considered within the discussion.

Key Words: Repurchase market; Federal Reserve; Inflation

JEL Codes: E51; E58; E31

Introduction

> *"Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of Society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose" - Keynes (1931, 77).*

The above quote from Keynes has been used often, but usually with emphasis on the first part of the phrase. This article will be based around the "hidden forces" on the "side of destruction" and how and why such "manners" are so difficult to diagnose. Fortunately, today the odds of a decent diagnosis are better than one in a million. However, as the communities of heterodox economics construct the diagnosis, there does seem to be a missing part. Specifically, this paper seeks to answer the question of where Wall Street money markets fit into the hypothesis of conflict inflation, which has gained traction during the past year, and to which this paper subscribes. In order to do so, we first offer some methodological and historical context to later get to the mechanisms and evolution of the repo market and the conditionality of their profitability upon the Fed's interest rates. The organization of the paper reflects the progression of this argument, beginning with considerations regarding the hidden forces of economics, then move into the seventies, then today's strange central bank reactions and how it all benefitted the participants in the repo market.

Shades of economic conspiracy

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices
- Adam Smith, 1776

There are few terms that switch off the attention of many readers like "conspiracy". Unfortunately, the tendency for people to join together and secretly plot against other is a historical constant, a part of what makes humans the "political animal"; conspiring against others is learned early, as can easily observed watching children play. In the adult world, conspiracies of many types are codified in legal systems: in the US, many were recently convicted of seditious conspiracy, while the RICO laws all revolve around criminal conspiracy, to give only two examples. In the world of international affairs, the art of espionage is little more than form of institutionalized conspiracy.

Economic conspiracy has likewise been a constant theme of critical economics. Throughout his writings, Keynes used the term conspiracy in an interesting way, usually referring to more broad phenomena and less to specific social conflicts, and when speaking of these, would convincingly describe a social conspiracy but not refer to it as such. We find such an example in Keynes's statement with which we opened this paper. Engaging "the hidden forces of economic law", and erecting public policy around faulty ideas on "the side of destruction", whether it is debauching a currency or other planned monetary events, certainly falls within some range of the broad spectrum of conspiracy. We can appreciate these within the spaces of academic and the press.

In academia, the granting of the 2022 Nobel prize for economists who analyze speculative bubbles without the ingredient of fraud (Marshall, 2020) is only one reminder that current mainstream economics is far from being a social science at the service of truth and understanding. John Kenneth Galbraith wrote in 1975 that "The study of money, above all other fields in economics, is the one in which complexity is used to disguise truth or evade truth, not to reveal it (Galbraith, 1975, 5); and towards the end of his life, emphasized on the importance of recognizing the innocent frauds of economics (Galbraith, 2004).

In all cases of conspiracy, be it economic, criminal or otherwise, it is in the interest of the conspiring parties to deny the possibility of a conspiracy -or at the least the appropriateness of mentioning it in polite company. Certainly there are many conspiracy theories that have been and are ridiculous, but a quick look at the history of science shows many absurd propositions that were widely accepted by the age's most trained minds;

likewise, ideas that were once widely derided - as conspiracy theory or otherwise - have been proven true. Facing the unknown, a critical and judicious discrimination of fact from fiction, would appear to be the correct stance when examining conspiracies. However, completely writing off anything unproven as untrue, both in economic theory and reality, can only lead to error.

A certain conspiracy of silence has long been part of academia's innocent sins. As Galbraith (1954,71) reflects, at at Harvard no one foresaw the market crash of 1929 or the beginning of the Great Depression, much as the economic mainstream also famously failed to see the second coming of it in the Great Financial Crisis (GFC) of 2007-2009. As Black (2010) has emphasized, academia's willful ignorance of fraud has created an important blind spot in mainstream thinking, much to the detriment of its predictive powers and claims to be a disinterested social science. While the likes of Lucas were claiming complete theoretical victory - the "central problem of depression prevention has been solved" (Lucas, 2003) - in real life, a vast criminal conspiracy was inflating the housing bubble. In academia, in the press, and in public policy circles, fraud became the "F-word" - unspoken and unspeakable (Black, 2010).

Fraud-led bubbles involve many layers of conspiracy. In the subprime crisis, there was a well documented collusion of real estate underwriters, ratings agencies, wall street traders and executives, government regulators and supervisors, and that was only at the market level (FCIC, 2011). The code of silence among the actors began to be referred to as *omertá* by the *Financial Times* and other members of the financial press, a term originating in a different criminal conspiracy - that of Italian organized crime. Somewhere between fraud and conspiracy is where *Financial Times* editor Gillian Tett found herself in the investigation of the 2012 Libor scandal:

> Sometimes in life it feels sweet to say “I told you so”. This week is one such moment. Five long years ago, I first started trying to expose the darker underbelly of the Libor market, together with *Financial Times* colleagues such as Michael Mackenzie. At the time, this sparked furious criticism from the British Bankers’ Association, as well as big banks such as Barclays; the word “scaremongering” was used. But now we know that, amid the blustering from the BBA, the reality was worse than we thought. As emails released by the UK Financial Services Authority show, some Barclays traders were engaged in a constant and pervasive attempt to rig the Libor market from 2006 on, with the encouragement of more senior managers. And the British bank may not have been alone (Tett, 2012).

Tett never mentions the word conspiracy in the article, but a "constant and pervasive attempt to rig the Libor market" would legally be classified as one, much like - to emphasize - the myriad other forms of corporate conspiracy and fraud that are codified in our legal system. Yet by entitling her article "Libor affair shows banking’s big conceit", Tett is not simply evading the "F-word", but rather using the term "conceit" to point the argument more in the direction of Galbraith's innocent sins, and the stark differences between reality and perceived reality in the context of high finance and the economy that it controls:

> But what the story of Libor shows is that this free market language has been honoured as much in the breach as the observance, to borrow Shakespeare’s

> phrase. And that was not just because a few Barclays traders were failing to "post honest prices", as the emails admit. Instead, the real issue was that Libor was never organised as a proper market in the first place, [...] For the tale of Libor is not some rarity; on the contrary, there are plenty of other parts of the debt and derivatives world that remain opaque and clubby, and continue to breach those basic Smith principles – even as bank chief executives present themselves as champions of free markets. It is perhaps one of the great ironies and hypocrisies of our age (Tett, 2012).

Much like Mosler (2010) extended Galbraith's innocent fraud to deadly sin, here we expand upon "the great ironies and hypocrisies of our age" to delve into money creation, debt, and the market prices of money on Wall Street, at the top of high finances where the processes of monetary creation are as important as they are shrouded in secrecy. Yet repo markets are not only under-reported by the financial press and understudied by academia, but are also strange markets in themselves, operating completely independently of economic theory and almost as disconnected from the productive economy. Far from the open entry competitive markets that they are assumed or claimed to be, they are "opaque and clubby, and continue to breach "those basic Smith principles" of free competition.

Indeed, it is one of the "great ironies and hypocrisies of our age" that the US repo market is one of the world's largest market by size,[1] yet is studied at a level of academic intensity more fitting for a neighborhood bake sale. Rarely investigated or understood, the state monetary issue through the repo market is not a conspiracy in itself, but the silence around it can be considered as such, particularly given the stakes.

The recent article " Money and the Public Debt: Treasury Market Liquidity as a Legal Phenomenon", (Menand and Younger, 2023) therefore arrived as a welcome surprise for anyone following Wall Street markets. The authors state that "The market for U.S. government debt (Treasuries) forms the bedrock of the global financial system", and that the repo market is a legal construct designed to create a new form of monetary issue. Menand and Younger's article is groundbreaking not only in identifying repo as a form of state money, but also in mentioning the many implications of this monetary issue. The authors date the creation of what they denominate the "Primary Dealer System" to the independence of the Fed in 1951 (Menand and Younger, 2024, 456), and connect the system to the expansion and strengthening of the post Bretton-Woods Dollar Standard (Menand and Younger, 2024, 456). The authors, both writing from Colombia Law School and Younger from the New York Fed as well, date the demise of the "Primary Dealer System" at 2008, giving way, in their terminology, to the "Shadow Dealer System". When the article was released, the *Financial Times* gave it a incredulous "so it was all just legal and monetary gimmicks?" (Scaggs, 2023), and importantly, was virtually alone in recognizing the significance of the publication.

Menand and Younger state at the outset a motivating factor for shining light into a particularly important blind spot of academic research - that the market is in trouble: "in recent years Treasury market liquidity has evaporated on several occasions and, in 2020, the market's near collapse led to the most aggressive central bank intervention in history" (Menand and Younger, 2023). The repo market operates and can be profitable to all parties under any interest rate environment. However, the system was designed to offer profit for its participants: "leading Fed officials agreed that [...] dealing in Treasuries had to remain

[1] At a (very) roughly estimated flow of 3 trillion a day with 12 trillion in outstanding debt (IMCA, 2019.)

consistently profitable. That required access to financing at lower rates than the secondary market yielded on their inventories—a so-called positive carry profile" (Menand and Younger, 2023). What the authors refer to as the "carry profile" is not sensitive to interest rates; it is merely Primary dealers selling what was given to them for free. However, the "carry trade" is a different story.

One of the biggest profit makers and easiest trades on Wall Street is to simply to borrow short term treasury debt in order to purchase longer term treasury debt - "riding the yield curve". The resulting carry trade is more profitable the higher the interest rate, and when interest rates fall to zero bound or lower, both the yield curve and profits are compressed. As seen before the pandemic, at such ranges, the market still functions, but at a lower gear. The combination of post-GFC regulations and the opening of the prime dealership to the Shadow Dealers has also caused a series of problems for the market, which will not be addressed now. Here, we only emphasize that a higher interest rate environment floats all boats in the repo market; that it is a very important market, both economically and politically; and that the seven decades of silence regarding this mechanism of state monetary issue fall into our spectrum of a conspiracy of silence.

Conflict inflation

As we soon expand upon, today's situation is similar enough to that of the 1970s to warrant comparison, as today like then, there was both a turning in the international monetary order (IMO) and also an international orchestration of interest rate increases, carried out through highly questionable methodologies. Certainly there are crucial differences both on the material plane and in the world of ideas. Whereas in the 1970s there was neither the critical mass of heterodox economics nor the media outlets necessary for a rigorous debate, the breakout of inflation in 2021 has fortunately been met by different conditions in academic work and diffusion. Particularly through the unifying outlet of the *Monetary Policy Institute* blog, today's bout of inflation has been analyzed from diverse angles and economic traditions, whereas the mainstream view, equally present and just as unhelpful today as it was yesterday, is a relative constant between the periods.

In heterodox debates regarding today's inflation, most support has been given to they hypothesis of supply chain interruptions and shortages provoked by Covid and the Ukraine war, which is also shared by the left of the mainstream and prominent Neo-Keynesians. Yet the focus of Post-Keynesians and other heterodox traditions goes beyond common ground when it begins to discuss profit inflation and the more social aspects of economics. Under the narrower mainstream lens, inflation can be presented as an enemy to all interests; under the wider heterodox lens, we can see economic interests that benefit more and less from higher and lower inflation and interest rates. As such, inflation is always and "everywhere a conflict phenomenon" (Hein, 2023).

Viewing money from a social lens, the notion that one of money's many functions is to serve as a tool in man's struggle against man (Ingham, 2004), becomes more apparent. What marks the biggest difference with discussions regarding inflation in the 1970s is the fact that this viewpoint now forms part of an open discussion on the historical record. Understanding money as a social rather than a natural or market creation is no small achievement, moving debate, even at very slow increments, into a much more realistic terrain in which social forces clash over money.

A useful starting point for situating conflict inflation is the classic consideration there are essentially three ultimate sources of value - land, labor, and capital (and for some, trade). There is correspondingly a constant balancing act between which sectors most contribute to overall production and which sectors benefit themselves most from the fruits of such production. Today's conflict inflation debate gives little consideration to land and trade, more correctly focusing on the conflict between labor and capital and the many ways in which this can be expressed in prices. Gallo offers a very useful summary and problematization of the position:

> A great deal of fuss revolves around the definitions of 'profit inflation' and the multifaceted notion of 'conflict'. In the context of profit inflation, the actors in the debate hold divergent views, sometimes identifying it as a persistent process driven by *greed*, some others linking it with temporary price level increases resulting from cost-push shocks and mark-up/profit share targeting. Similarly, the term 'conflict' holds nuanced interpretations. On one hand, wages could be seen as the exclusive source of conflict, while on the other hand, the actions of profit earners defending and seeking to increase their margins could also be regarded as instances of social conflict (Gallo, 2023).

The incorporation of the repo market and the interests of its principle actors does not enter into conflict with the varied heterodox positions regarding the post-pandemic interest rate hikes; rather, it adds a new dynamic into the conflict inflation framework of competing claims on a economy's surplus. Capital has long been treated in a similar fashion to land or labor -something that exists in a relatively fixed quantity and that cannot be easily or quickly created. Gold is the prime example in theory and (historical) reality. As Polanyi pointed out decades ago, the escape from the monetary scarcity of gold has occupied the mind and actions of man for centuries, and different forms of money have once and again arisen to alleviate the social strains of the monetary scarcity imposed by a gold standard (Polanyi 2001 [1944], 202).

Yet updated to more current times, we find that a relatively new and abundant monetary issue only creates new social struggles. Rochon and Seccareccia (2013, 4) have emphasized the inevitability of social conflict in economies that rely on extortion rather than credit creation for monetary accumulation. While in agreement, it is curious how, at least when considering the rise and fall of the primary dealer system, the inverse is not true. Even with a regime of accumulation based on credit creation, the abundance is never enough, and conflict arises. On Wall Street, the struggle became one of who had the exorbitant privilege of bringing state money (Treasury debt) to the repo market where it is sold for a profit- who can be the closest to the monetary spigot and under what terms. The repo market is not only a US market, nor are Primary Dealers only US banks - this struggle for positioning is an international affair. As a defining part of the IMO, the primary dealer system "was part of the dollar's expansion of both economic and military might" (Menand and Younger, 2023), which has likewise not led to less conflict.

Subterfuge in the seventies

As mentioned, today's present situation finds an important historical parallel in the 1970s, not only in the public policy actions of the Fed and other central banks, but also in the duplicitous ways in which these were carried out. What was presented at the time as a unilateral move from a loose cannon in the Oval Office could later be more fully understood as Wall Street overcoming limits to its (and the US's) financial and military expansion. In the little understood institutional setting of the IMO, it is an issue that confused most economists at the time and continues to confuse today. In the subsequent years, Friedman (1980) would convince many that the inflation of the decade was the result of oil shocks related to wars in the middle east. Yet years later, Friedman's fellow Nobel Winner Mundell (1999) would present a more convincing story, in which US monetary emission had gotten so far ahead the dollar peg that its abandonment was the equivalent of a massive devaluation of the dollar against all other currencies, certainly reflecting then Treasury Secretary John Connally's famous observation at the time that dollar is "our currency but your problem" (Volcker, 1978: 6). Shortly before his death, Volcker came clean over his role: "I certainly was a major proponent of suspending gold convertibility, in fact the principal planner" (Feldstein, 2013, 2).

Volcker signals in a 1978 speech that the US was beginning to feel the "external constraint" - the faintest of tightening of the paper shackles of gold. Once the gold peg was lifted and the dollar's devaluation washed over the world in an inflationary tide, it would be a short few years until it was rolled back through rate hikes to levels high enough to break the most exposed debtors, and to pull money from all other sectors into Treasury debt. The 1970s saw the birth of financialization, accompanied by its hideous twin - disaster capitalism (Déniz and Marshall, 2018; Klein, 2007). In the same 1978 speech, Volcker declared that "a controlled disintegration in the world economy is a legitimate objective for the 1980s" (Volcker, 1978: 2).

Wall Street created and cured inflation with a monetary three step within the span of a decade, first in the last moments of overspending the peg; then by breaking it; and then through the rate hikes. Volcker was at the helm at all points: "we have plain enough warning of the fact that international money, any more than domestic, will not manage itself" (Volcker, 1978: 10). Management assumed the form of disaster capitalism. In the US, the Volcker shock was administered to open up the Savings and Loan sector to Wall Street (Black, 2005). At the international level, the management of the Latin American debt crisis involved the repurposing of the international monetary fund (IMF) into a debt collector for Wall Street: "all of this raises questions of governance - if the system is to be managed, who will do it and how. The obvious international focus is the IMF" (Volcker, 1978: 12).

As little as the transition from the Bretton Woods to the Dollar Standard was understood at the time, the Volcker rate hikes relied even more on deception, and are therefore instructive for today's situation:

> The import of their decision was clear to the FOMC members. They were voting, in effect, to put the national economy into a contraction. That was the expected outcome, and Volcker himself confided his own pessimism to colleagues [...] When the press was summoned in late afternoon, that is not what the Federal Reserve told the American public. The announcement was couched in technical language that financial traders might understand, but

> the words had no meaning for average citizens or even most politicians. There was nothing said about what the Fed intended for the US economy. In fact, when a reporter asked Volcker if the likely result would be slower growth and higher unemployment, Volcker evaded the point and concealed his real expectations (Greider, 1986: 123).

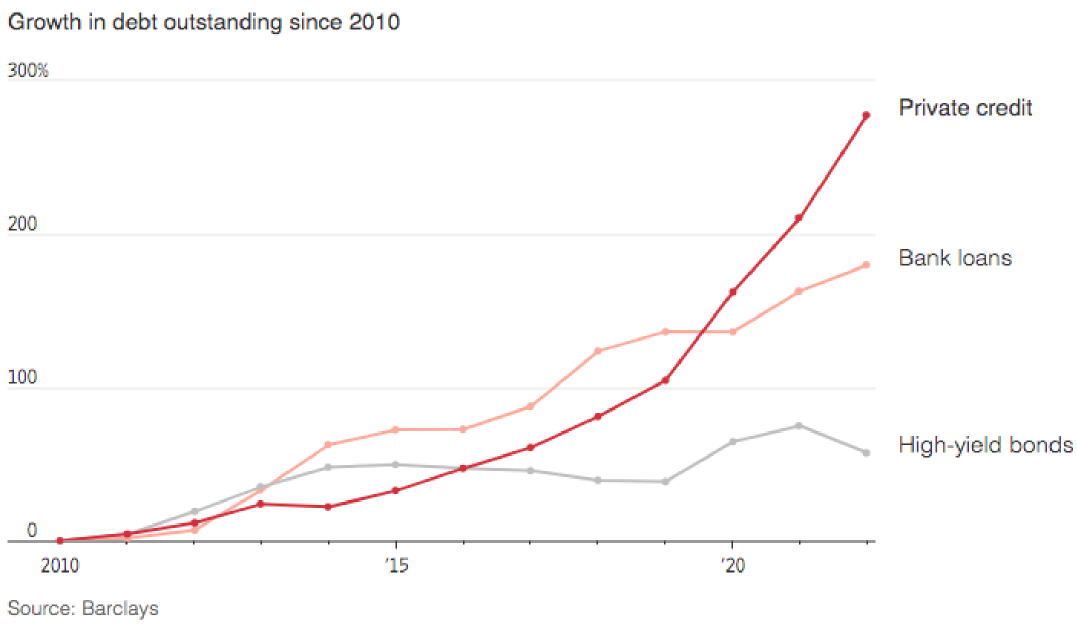
During the 1970s it was clear to most that Volcker represented Wall Street, having been David Rockefeller's right hand man as Vice President of Chase Manhattan, among other posts, before being chosen as Fed chairman: "Stuart Eizenstat, the President's domestic policy adviser, explained Jimmy Carter's fateful choice: 'Volcker was selected because he was the candidate of Wall Street" (Greider, 1986: 47). And while Volcker's hand was hidden in the decision to end the gold peg, a different type of deception was involved in the rate hikes - the supposedly new methodology of monetarism. The ultimate effects of the rate hikes - breaking open the Latin American financial markets and the US housing markets - clearly served Wall Street's expansionist interests.

Tellingly, even the intellectual tool used to deceive was not permanently damaged by the episode. The monetarist ideal of controlling the quantity of money in an economy was declared incorrect even by its most prominent proponents. Milton Friedman would state that “the use of quantity of money as a target has not been a success... I’m not sure I would as of today push it as hard as I once did” (Stern, 2007). Friedman's frequent collaborator Anne Schwartz would also posteriorly state that "observers who were not monetarists described the Fed’s new procedure as a subterfuge. It permitted the Fed to raise the federal funds rate to unprecedented heights while alleging that it was not itself acting on the rate" (Schwartz, 2005). From a non-monetarist viewpoint, we would certainly see it as subterfuge - confusing matters in order to advance a plan of monetary "controlled disintegration". Regardless, Schwartz states that "the monetarist debate with the economics profession is in abeyance, but monetarist tenets are now incorporated in mainstream economics" (Schwartz, 2005). We therefore finish with the 1970s where we started: conventional economics remains trapped within a woefully inadequate theoretical framework, and now once again faces another internationally orchestrated rate hike in the midst of a shifting IMO.

As the world churns

Toward the end of 2023, the headlines of the financial press signaled the completion of a cycle for the "shadow dealers", composed mainly of the largest private equity and hedge funds that grew from the new entrants in a market under conditions of historically low profitability, to dominant participants in a suddenly very profitable market. Albeit hardly noticeable, headlines did follow: "Private equity chiefs enjoy $40bn gain in share value as assets surge. High interest rates have provided good news, with earnings boosted by growth of credit operations" (Gara, 2024). Headlines also acknowledged the changing conformation of Wall Street: "The new kings of Wall Street Aren't Banks. Private Funds Fuel America: with interest rates at multiyear highs, hedge funds and private equity are taking over lending" (Wirz, 2023). The article includes a graph which we reproduce below, along with the statement that "Private credit funds are taking over the corporate lending market, with assets under management rising to $1.5 trillion in 2022 from $726 billion in 2018. This shift is being driven by a number of factors, including high-interest rates" (Wirz, 2023). The financial press in general has agreed upon who the kings are, and that higher interest rates lead to more profits, but go little beyond the common narrative that "as the economy recovered [from the GFC], private-markets firms flourished - emerging as the new kings of Wall Street" (The Economist, 2023).

Figure 1



Source: Wirz, 2003

Sources of Wall Street Credit

We therefore pick up on what the financial press signals but does not explain in any significant detail: the reconfiguration of the Wall Street landscape; the evolution of interest rates; and the connections between profits and higher interest rates. But first we offer historical context to the first point, for the new kings were ascendant within Wall Street at a same moment in which Wall Street became more ascendant over the rest of the economy. This evolution included the transition from an overdraft economy based on productive credit to an asset backed economy based on money markets and trading (Lavoie, 2003), as well as the concentration of the national credit system, going from one of many credit institutions financing a diversity of productive enterprises, to a narrower association between monopolistic banks and monopolistic producers. Overall, this has led to a aver growing dominance of the financial economy over the productive economy (Temin, 2018).

Following this evolution of the market was a secular downward trend in interest rates until the pandemic. During this period, successive and ever larger bubbles offered a temporary escape from creeping deflation, but the subprime bubble proved to be the last bubble that the private market could blow. With the bubble machine broken, more drastic alternatives were explored:

> Of course, the underlying problem in all of this is simply that real interest rates are too high. But, you say, they're negative – zero nominal rates minus at least some expected inflation. To which the answer is, so? If the market wants a strongly negative real interest rate, we'll have persistent problems until we find a way to deliver such a rate.
> One way to get there would be to reconstruct our whole monetary system – say, eliminate paper money and pay negative interest rates on deposits. Another way would be to take advantage of the next boom – whether it's a bubble or driven by expansionary fiscal policy – to push inflation substantially higher, and keep it there. One way to get there would be to reconstruct our whole monetary system – say, eliminate paper money and pay negative interest rates on deposits. Another way would be to take advantage of the next boom – whether it's a bubble or driven by expansionary fiscal policy – to push inflation substantially higher, and keep it there (Krugman, 2013).

The quote includes an important non sequitur. A way to deliver negative interest rates is the elimination of paper money, but Krugman's "another way" speaks of ways to deliver positive interest rates through inflationary forces. Nevertheless, we focus on the idea that that society must give the market what it wants or "we'll have persistent problems", with the caveat that in terms of higher rates, to "get there" and to "keep it there" are different battles. While the pandemic produced many means and ways for inflation to rise, some more legitimate than others, the long term deflationary trend is much more difficult to break.

Shortly prior to the pandemic, Tett commented that negative interest rates had created a market environment in which "economic logic - or gravity- has been turned on its head" (2019). The market certainly become strange, but so did all of its supports, whether in the state or broader society. Once an enormous market collapse occurred in the form of the GFC, a cycle of debt deflation á la Irving Fischer set in, and "black hole monetary economics" (Summers, 2019) ensued: the more the money thrown at the problem, the more power the monetary black hole gains. As has been argued elsewhere (Marshall, 2020; 2013), the only way of recovering from a episode of "it" is wholesale market reform. Otherwise, the transfer of state money to commercial banks is "pushing on a string". Yet in investment banking, and in particular the repo market, it is more similar to throwing money into a black hole. The growing appetite of the back hole is clearly evident with a quick glance at the evolution of Fed's balance sheet post GFC, and only slightly less so in the wildly expanding Treasury debt. The black hole's ability to grow is also facilitated by the mentioned transition to an asset-backed financial system and the growing concentration in the banking sector. The greater dominance of the financial sector over the rest of the economy creates a situation in which even a well spread fiscal stimulus would be in large part sucked up by the financial sector rather than circulated in the real economy to stimulate aggregate demand (Rochon, 2009).

Seen through the lens of the circuitist perspective, the underlying black hole problem more clearly reveals itself as a broken or open financial circuit. Through the many forms of the financial sector bailout, most prominently QE, but also before and after by means of the

Primary Dealer system, the state in conjunction with private banks creates new money, but it remains in the financial circuit and does not become active productive capital as occurs with commercial banking. The resumed circuit of either QE or the repo market is state debt to investment banks to capital markets to offshore hoards of accumulated capital; these circuits serve little more than to enrich market participants. Asset backed circuits do not include bank loans or any significant connection to the productive apparatus - it is completely disembedded from society. But it is also a broken or open circuit in the sense that there is no reflux stage or mechanism. Money is created out of state debt, but with none of the effects of a Keynesian multiplier. It is essentially created and buried in the ground, never to be dug up (Keynes, 1936: 68), but it is not innocuous either, as no currency can withstand broken plumbing at such levels for too long.

There are myriad forms to close the black hole, and many ways to to keep feeding it. But its growing gravitational pull is evident, ingesting banks, central bank balance sheets, positive interest rates, and physical cash. Then president of the IMF Cristine Legarde began calling for a "great reset in monetary policy" in Davos in 2014 as the banking business was being dragged down by the negative rate environment (Marshall and Correa 2020). A decade later, "a way to deliver such a rate" has been found, yet it does not seem that our "persistent problems" have reached an end.

The lockdown and conflict inflation

The 2020 pandemic was a moment of heightened change and intense uncertainty. It radically changed society, work and money, as well as prices. The lockdown policies of the pandemic created widespread social and economic destruction in another example of disaster capitalism (Klein, 2020, Correa and Marshall, 2020). On the economic front, the closing of ports and the suspension of much transportation activity, as well as other key shortages, caused supply side problems, while in most countries of the center, and some in the periphery, governments offered funding to support the demand side of the economy. In countries such as the US, there are therefore two possible sides of inflationary forces.

Conventional thinking links prices and economic activity to the supply and demand of money and goods; inflation therefore results from too much money and too few goods. We will soon criticize this vision, but for now only note that even if true, it would not justify - nor could it explain - the coordinated global rate hikes that began in the summer of 2021. A common narrative at the moment was that "we have an overheating economy" (Tappe, 2021) and a consensus soon formed that central banks must "act decisively to cool down an overheating economy before inflation worsens" (Strain, 2022). Current central bankers hold an even more reduced view of inflation than conventional thinking offers, and the formula is simply that higher prices are the result of too much money in the economy, and that as higher interest rates soak up money from circulation, then the problem is easily solved.

In what has now become old hat for popular media consumption, two cards are shown and match - prices and interest rates increases - but other cards are left out. We can imagine a variation of the three card monte hustle. The name of the game is "how to cure inflation". The curtain opens and there are are two lines of three cards, one red and one blue. The table marks a progression of three spaces: supply and demand, the prices of goods and money, and the final point of the game - whether to raise interest rates or not. The red cards are turned over. Card one is the problem of restricted supply. Card two shows supply side inflation. Card three is flipped and exclaims do not raise interest rates! The blue cards are turned over.

Card one is the problem of excess demand. Card two reveals demand side inflation. Card three is flipped and exclaims, raise interest rates! The cards are now turned back over. The economic magician appears, turns down the lights and flips over two cards as opposed to the normal three: excess demand, and raise interest rates! The magician exclaims, and the curtain draws. The audience is left mouth agape, assuredly by the intellectual audacity of solving a three step problem in only two.

Indeed, there were those who used the red deck and those who used the blue one. Summers was among the more prominent economists to make a consistent blue card argument, claiming that Covid relief was too generous, and caused demand-led inflation, whose only cure would involve years of rate hikes and unemployment rates of up to 10% (Mellor, 2022). Others were inconsistent in their arguments. Krugman, for example, placed emphasis both on the supply and demand side: "supply-chain problems that are driving up many prices" ... [but] "the reason everything is delayed is that people are trying to buy more stuff than ever before, and their demands are outstripping the supply chain’s capacity" (Krugman, 2021). But like his peers, Krugman settled on the blue card: "the Fed must hike: Inflation must be curbed, and as a practical matter, interest rates are the only game in town"(Krugman, 2022a). There were no prominent economists to walk the red card line and recommend no rate hikes, which is curious, given the rare opportunity to demonstrate the self-correcting market system in action: given a supply chain interruption, the higher prices of effected products should lower the demand for them, assuaging the demand problem, and as supply chains are restored, prices would fully adjust and no further action would be needed.

As much as prominent economists claim to the contrary, markets are rarely self - correcting, and the red card / blue card presentation is much too simple to encompass complex realities. Within the strict limits that it imposes upon itself, conventional thinking has often showed sharp inconsistencies in its treatment of recent inflation, and once conventional thinking itself is questioned, the situation becomes even more embarrassing. There are many measures of inflation, and what the pandemic indeed showed was a bifurcation between aggregate demand and prices: workers receive less, and prices in general rise. As production was interrupted and fell - with many sectors of the economy yet to recover - only government spending could replace lost wages. Yet wages were not replaced across the board, nor across the world. Where it was absent, in many cases meager savings were drawn down and households spent less, yet prices still rose.

As happened in much of the world during the pandemic, long-standing patterns were accentuated, yet under new forms. On the aggregate, worker salary per share of national production did not change its long downward trajectory, but work was bifurcated in strange and novel ways, and has produced many important secondary effects. To take an important example, remote work has emptied out cities and can only be considered as deflationary for both the financial and productive economy. While remote workers may earn the same or more and prefer to work from home, it vastly changes the landscape of work, both socially and geographically. Decades ago, as manufacture began offshoring from what is now the rustbelt, many celebrated the birth of the service economy that was concentrated in major cities. However, as the economic age once again turns, the urban service economy is now one of the hardest hit. Remote working has left many city centers feeling abandoned, billowing ominous signs for the commercial real estate markets, but real apocalypse for those who would serve those in the city during the day in restaurants and shops, or at nights and on the weekends in theaters, bars, movie theaters, and night clubs of all sorts. Such changes in work have unleashed deflationary forces across many areas of the economy - and society.

In terms of labor sociology, the pandemic brought an abnormally high number of work protests and strikes across almost all sectors, and also an increase - at least in the media coverage - of quitting or "stealth quitting". Krugman helped popularize the idea of the "great resignation": "What we're seeing, of course, is the Great Resignation — which is also, to an important extent, a Great Retirement. A recent blog post from the International Monetary Fund shows that there has been a surge in the number of older Americans (and Britons) choosing not to be in the labor force" (Krugman, 2022b).

The pandemic period also included political gains not seen by organized labor in decades in the US, with presidential support of organized labor coinciding with important wage increases for many formal workers. But at the same time, the rapidly growing sector of informal gig workers saw their wages compressed in many forms, while a sharp increase in immigration, particularly from Venezuela, also increases inequality among workers, albeit providing "one of the key factors that have allowed America to combine solid economic growth with falling inflation" (Krugman, 2024). To emphasize, the wage share to national production dynamic only continues its downward trajectory. Even the mentioned salary increases do not depart from the tendency, as formal workers are paid more in part because of increased productivity, be it from robotization or perpetual corporate rightsizing. Taken together, the growing underclass of informal workers and the higher paid but more reduced group of formal workers do not summon an inflationary force.

In a context in which both labor and finance are on a deflationary trajectory, financial and non-financial corporations continue to register record profits. Such a situation is baffling under a supply and demand based price theory. Decades ago, JK Galbraith argued that the myth of the free market determining prices merely hid the reality of administered prices. To an ever greater degree, prices are determined by monopolic corporations. Yet the myth persists. The fact that international free trade agreements that could be written in a few phrases range into the thousands, belies the fact that they are in reality administered price agreements. Instead of prices responding to supply and demand, monopolies charge what they feel best for their interests[2]. If coordinated, markets can get what they want; yet there are certainly limits.

From the more ample spectrum of heterodox theory, Gallo introduces the concept of profit inflation:

> In the unprecedented scenario of the post-COVID recovery, many firms — especially in those sectors labeled as 'strategically significant' by Weber and Wasner — did not limit themselves to defend their profit margins, but have actively tried to increase them by endogenously raising their mark-ups. This is undeniably what profit inflation is about (Gallo, 2023).

The corporate incentive for recurring to profit inflation would seem fairly obvious, as would the ability to do so. However, in the era of the much analyzed financialization of the corporation, it is curious to note that profit inflation has not been a significant mechanism for the maximization of shareholder value: "Firms cannot, however, raise mark-ups at will.

[2] During the pandemic, it was fascinating to track the price and availability of a Washington apple between my mother's closest Wal Mart in Florida and mine in Mexico City.

On the contrary, mark-ups should be seen as strongly dependent on sectorial mark-ups, in turn affected by competition, concentration, and profitability constraints?" (Gallo, 2023). We would only add to Gallo's criteria that while firms cannot raise profits at will, Wall Street certainly has the power and mechanisms to be a coordinating force for the "sectorial mark-ups"; whether it has the will is another question, but it does have the incentive.

Wall Street's varying degree of control over productive corporations has at intervals over the last century been at the center of American politics. Yet even though Wall Street has concentrated the economic life of America as never before, there has been no recent equivalent to the Pujo Committee to examine the money trust of a century ago. Indeed, inquiries into Wall Street concentration would not have to go very far, as private equity firm BlackRock is at once one of the largest shareholder's in corporate America - very much including the banking sector - and there is no secret made of it. Regarding incentives in this one-firm case, there are both financial and commercial interests to be considered, but under monopoly conditions, they are both simultaneously served by an increase in retail prices, as higher prices at once lead to higher corporate profits and the policy response of higher interest rates, which lead to higher profits in the repo market. The profitability constraint is not eliminated, but simply moves beyond the market realm into the political realm.

While we insist that the possibility of a potemkin inflation constructed at the behest of high finance should at least be considered in the discussion regarding conflict inflation, we also insist that the debate must not only include the source of the post pandemic inflation, but also its cure. Much like the concentration of monopoly capitalism under Wall Street's guidance would permit coordinated price hikes on one end, the conversion in recent decades of the majority of the world's central banks into independent central banks pursuing inflation targeting schemes at the behest of high finance (Marshall and Rochon, 2023) would likewise permit coordinated policy response on the other end.

Monetary Policy

Much like idea that prices derive from supply and demand, the limited conventional thinking regarding monetary policy quickly runs into trouble as well. We take a representative example: "the working class faces no greater thief than inflation. The rich can switch among asset classes, find different tax shelters, rely on financial experts, ride it out. The less fortunate — your constituency and much of the Democratic base — depend on regular paychecks to pay the rent" (Stephens, 2021). Inflation is most often framed from the perspective of the price of things that money buys, but rarely from the perspective of money. Seen from this perspective, inflation is when money loses its value relative to what it buys, and inversely, deflation is when money gains ground on what it can purchase. Through this lens, it becomes clear that those with the greatest accumulations of money have the most to lose from inflation. The statement that those with less suffer more from inflation is correct, as they spends a much greater percentage of income on food and other basic necessities. But they do not lose more. They are not the victim of a "greater thief", for as any great thief knows, more can be stolen from the rich than from the poor.

If the goal were to protect the "less fortunate", there are many avenues of fiscal policy that can directly improve their material conditions, even in an inflationary environment. Yet there are few options to protect piles of cash against the rot of inflation. The viability of Stephens's options for protecting accumulated paper assets descend in the order presented in the above quote. First, perhaps some assets will perform better than others, and pushing cash into equities or bonds could be a good bet, but the whole point of dollars is to have them be the "ultimate safe asset" when there are no good bets. Second, dollars are no safer against the losses of inflation regardless of which "tax shelters" they find themselves in. The remaining strategies of asking someone else, or doing nothing - "ride it out" - are less strategies than evidence of a lack of strategy.

In the wake of the GFC, many that chose to "rely on financial experts" were pushed into the commodity bubble of 2009. Experts that relied on monetarist theory were breathlessly predicting the onset of inflation or hyperfinflation as a direct consequence of bank bailouts and fiscal stimulus, and that the only inflationary hedge was commodities (Wray, 2008). Depending on when one got in and out on the bubble, there was certainly money to be made. However, the investment strategy was errant, as there was no need to take such a risky move out of a safe asset, still a decade away from our current bout of relatively mild inflation. The size of the commodities bubble underlines that faced with the devaluation of the world's safest asset, many investors could do no better than "relying on financial experts"; there is no clear way to shield paper wealth from inflation.

For their part, the "most needy" may get more stable prices through higher interest rates, but not lower prices, and much less better paid employment. On the other side, for the interests of financial rent, higher interests rates represent a double victory, as higher rates at some point will crush inflation, while simultaneously raising the profitability of a large array of financial assets. The statement that inflation hurts most those with less, is correct; the notion that it does not hurt the interest of financial rent is not. What could seem a minor point blossoms into immoral public policy when the only solution for inflation becomes raising interest rates, which clearly benefits those with more at the expense of those with less.

Yet the mainstream calculus in which inflation harms all classes runs into inconsistencies in other areas as well:

> If inflation does fade as policymakers expect, the current burst could actually offer benefits: In the United States, it has helped to nudge inflation expectations back out of the dangerously low zone, to levels that are historically consistent with healthy price gains. It has proved harder for central bankers to move prices up than it is for them to cool them off, so that opportunistic inflation could help the Fed to nail its price goals in the longer run (Smialek, 2021).

Connecting the "dangerously low zone" of a decade ago with "healthy price gains" allows for some conclusions to be made. From their nadir of 2009, equity markets have been on a historically steady increase, fairly closely tracking QE disbursements. Other assets, such as house prices and Bitcoin, have likewise seen a strongly upwards trajectory. The bond market has mirrored the experience in inverse. Since the Volcker shock, Treasury rates have followed a steadily downward trajectory, greatly accentuated during the pandemic.

Such interest rate trajectories impact different financial markets in different ways, and likewise all types of private interests in all types of forms. Krugman states that "anyone interested in economic policy should know that the history of how 2 percent came to define 'price stability' is peculiar, and that the argument for keeping that target is grounded less in straightforward economics than in almost metaphysical concerns about credibility" (Krugman, 2022). What is often called the neutral or natural rate is precisely the opposite. It is a policy rate, as Seccareccia (2020) emphasizes, and is determined through a political rather than market equilibrium. When Krugman speaks of having "persistent problems until we find a way to deliver such a rate", the problems are of a political nature.

Therefore, when Krugman debates whether the target rate should be 4% or 2% - “are the net costs of inflation much higher at, say, 4 percent than at 2 percent?” - it it is not a debate of market net costs: "there’s no real evidence to that effect" (Krugman, 2022). A political framework for understanding the decision would have to begin with the diverse financial interests on Wall Street, in a bit of Rubik's cube relationship as to who's who in which markets and how different interest rates effect them. The task is made easier by a few basic considerations. A century ago, Keynes stated that "deflation [...] involves a transference of wealth from the rest of the community to the rentier class and to all holders of titles to money " (Keynes, 1931: 190). Within this scenario, "the wise man is he who turns his assets into cash, withdraws from the risks and the exertions of activity, and awaits in country retirement the steady appreciation promised him in the value of cash"(Keynes, 1931: 189).

Seen from the perspective of the banker, for the extension of new money, a 2% floor offers a significant subsidy for the creditor at the cost of the borrower, whether in commercial or investment banking. Yet while in the first case higher rates at some point lead to lower lending, the same does not hold for the latter. When investing in government debt, whether longer term or running a carry trade, the higher the rate the better. The gravitational shift of banking away from commercial banking towards asset backed investment banking on Wall Street, centering around the spigot of state monetary creation - the repo market - means that higher interest rates are now clearly in the majority interest of banking.

Conclusions

If we can think of inflation as a private tax on society's material provisioning, and the more that its provisioning is dependent upon monopolies, the more effective the taxation, than we are in the terrain of Smith's "conspiracy against the public, or in some contrivance to raise prices". The heterodox position that considers conflict inflation is a welcome addition to the inflation debate. The "lords of the jungle do not hunt by daylight" (Tawney, 192, 68) and the proposal that all of economic activity happens in the light once and again leads to erroneous assumptions, which can bloom into academic embarrassments and disastrous political policy. Again, the period around the GFC provides ample examples.

In the spring of 2024, the big question is whether the post Covid inflation spike is a temporary blip on the inflation graph, or if it will be followed by further inflationary surprises. It is a perilous debate to wade into. Putting economic forces at the fore of analysis, deflation retains great gravitational pull and a rise in prices can only be seen as brief. Yet there are more than economic forces at work. Krugman conjures the notion of supernatural forces at work when he argues that we are witnessing a "divine deflation" (Krugman, 2024).

We would rather argue that social forces are at work. If we can take the metaphor of a cross section model of Earth, the economy would be the Earth's crust, happily ignorant of what is happening beneath it until volcanoes and earthquakes tear it up. All economic forces are constructed upon social structures - which themselves are in constant transformation - and there are moments when underlying forces explode to the surface and economics can have but little to say about it, other than it comes from an area outside of our study. And much like science can only get so far down into the Earth's mantle, few outside of the direct participants at the top of the social pyramid know exactly the details of the decisions that lead to moments of great historical change. Exactly what will happen in the coming years with the IMO and therefore prices around the world is one of the more intriguing questions facing us, yet few economists even recognize the IMO, much less treat it as an institution.

All great turnings of Earth's geopolitical poles involve war and money and can be measured in the starting and ending points of the history's IMOs. While the world wars put an end to *Pax Britanica* and the gold standard, the subsequent *Pax Americana*, divided in two between the Bretton Woods order, and the pure Dollar standard, appears to be nearing an end. This will certainly have an effect on prices: “The Russian invasion of Ukraine has put an end to the globalization we have experienced over the last three decades As a result, a large-scale reorientation of supply chains will inherently be inflationary (Krugman, 2023). However, as history has shown, when such moments occur, money is the least of the two big concerns. Wars were limited in scope in the 1970s. Today, concerns over peace would certainly seem to trump those of money, both in a rooting stake for humanity, and in monetary analysis.

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