XIII. INFLATION

A. Confusions Resulting From the Definition of Inflation as Rising Prices

1. Too many explanations, causing ignorance in any particular case.
2. Implication of the responsibility of businessmen.
3. Implication of price and wage controls as the solution.
4. Implication of limiting inflation by expanding the quantity of money.

Alternative definition of inflation in terms of the increase in the quantity of money.

B. Validation of the Quantity Theory of Money as the Explanation of Rising Prices

1. The demand/supply test using the formula for the general consumer price level.
2. By the nature of the formula, the price level can rise only by virtue of more D or less S.
3. Reductions in supply must be ruled out as a cause of an inflationary rise in prices because:
   a. Supply has actually increased.
   b. Even where supply has decreased, the overwhelmingly greater part of the rise in the price level has been the result of more demand.
   c. Reductions in supply could explain a sustained, significant rise in prices only if material civilization were in the process of rapidly disappearing, which it isn't.
   d. A decrease in supply is often itself merely an indirect consequence of a rapidly rising aggregate demand, rather than being an initiating cause of rising prices.
   e. Decreases in supply do not produce the range of price increases people associate with inflation.
   f. Decreases in supply do not produce the effects on the relations between debtors and creditors that people associate with inflation.
   g. To say that decreases in supply cause inflation is to imply that increases in supply cause deflation and, therefore, depression and poverty. This is a self-contradiction because more supply causes prosperity, not poverty.
4. Thus, the problem of inflation is exclusively one of rising aggregate demand.
5. A rise in aggregate demand is the result of an increase in the quantity of money: recall the examples of the gold mining case and of the issuance of social security checks from Chapter 12 and the discussion of the ways in which more M raises V.
6. Governmental responsibility for inflation.
   a. The forced abandonment of gold and the creation of fiat standard money through the open market operation.
   b. The encouragement of fractional reserve banking and fiduciary media: expanding the amount of reserves through the open market operation and making reserves more potent.
7. The implied solution for inflation: *take the ability to create money out of the government's hands:* make the monetary unit something the government cannot create—viz., *gold.*

C. Alternative Explanations of Rising Prices: The Cost Push Doctrines

1. The cost-push doctrine: the attempt to blame rising prices on rising costs of production. Variants of the cost-push doctrine: wage-push, profit-push, the wage-price spiral, crisis-push.

2. The roots of the cost-push doctrine: the belief that more demand causes more production and supply and can only raise prices at the point of full employment ("demand-pull inflation"). The belief that in the absence of full employment another explanation of rising prices must be found. Rising costs selected as the explanation because in first instance costs often do determine prices.

3. The logical deficiency of the cost-push doctrine: explaining prices on the basis of costs means explaining them on the basis of other prices and ultimately on the basis of mere arbitrary power.

4. The cost-push doctrine is equivalent to blaming inflation on falling supply. All the objections raised against falling supply as an explanation of inflation apply to it.

5. Critique of the wage-push variant:

a. If demand did not rise, wage push would burn itself out in mounting unemployment. The total cumulative effect of wage push would be limited and probably could not stop prices from actually falling.
b. Wage push is a continuing phenomenon only because of governmental decisions to increase the money supply and expand demand in an effort to avoid or fight the unemployment otherwise resulting from wage push. Wage push is thus actually a consequence of an expanding quantity of money and more demand.
b. Confirmation by the experience of the 1980's.

6. Critique of the profit-push variant.

a. Even a protected legal monopolist can raise his price only if the demand for his product is growing. In order to be associated with a problem of inflation, the growth in demand for the monopolist's product must be part of a growth in economy-wide demand.
b. The actual effect of the profit motive is to expand production and thus reduce prices; this confirmed even by the rise in prices in paper money.
c. Inflation is associated with high profits. This is because an expanding money supply and demand increase sales revenues. The increase in profits is purely in terms of paper money and is usually accompanied by a decline in real profits: the inventory case.

7. Critique of the crisis-push doctrine.

Confusion of non-repeatable, particular price increases with sustained general price increases.

D. Alternative Theories of Rising Prices Continued: The Velocity Doctrines

1. The basic velocity doctrine: the attempt to blame increases in aggregate demand on a higher velocity of circulation of money rather than on a larger quantity of money.

2. Critique of basic velocity doctrine.

a. Velocity not an entity or cause of anything; reflects desire to hold money in reserve.
b. This desire mainly determined by rate of increase in the quantity of money, as explained previously; thus rise in velocity itself mainly a reflection of increase in quantity of money—more rapid the increase, the less is the desire to hold money, and thus the greater is velocity.
c. Independent decreases in demand for money and rise in velocity slow and gradual, and largely offset by more complexity of production involving more stages of payment and by more production.

3. Critique of the inflation psychology doctrine:

a. Inflation psychology not a primary—the product of the fact of inflation; quickly diminishes in the face of a serious attempt to reduce inflation, as the experience of 1980s confirms.
b. Largely describes same factors as make for higher V; but also operates from the side of supply, in the anticipations of sellers: higher wages and prices than corresponds to current D. To this extent, like cost-push

and with the same limits. Implication here of inflation causing unemployment via wages and prices outrunning rise in D.

4. More on inflation psychology: can appear to lead life of own—can continue for a while even if government sharply cuts back or stops inflating for a while; people go on with low cash holdings or reduce them further, and go on raising prices in expectation of being bailed out by more inflation. At this point, a crisis necessary to break inflation psychology—government must not validate inflationary expectations, not bail people out as demand appears inadequate, as credit fails to materialize and cash holdings prove inadequate. Appearance of crisis easily leads to resumption of more rapid expansion of money—to stop, mitigate, or turn the crisis around; can lead to undoing of paper money by making inflation worse than before, producing still more rapidly rising prices and still worse inflation psychology on the next round, with problem getting worse and worse as time goes on. Validating inflation psychology not possible on the gold standard.

5. The credit-card doctrine:

a. Thesis: reduce need to hold M—raise V.

b. Largely *apparent* reduction in need to hold M: American Express type card: hold checking balance instead of currency, *two* cash holdings instead of one (American Express's and yours); probably acts to *reduce* V.

c. Sometimes credit cards can reduce the need to hold cash: Visa and Mastercards; here we have lines of bank credit—guaranteed loans. Don't need to hold cash for case of finding something and not being able to borrow; now sure to be able to borrow. But what makes possible this great extension in lines of bank credit is ability to expand M—an instance of more M reducing need to hold M and thus raising V. Confirms quantity theory.

d. credit cards and lines of bank credit can certainly exist without inflation, but only on basis of *savings*, where origin is drop in consumption of the savers; thus, if not based on more M, not inflationary.

6. Consumer installment credit and credit in general—inflationary if from more M; not if financed by saving.

7. Consumer "greed"—vague: might refer to some goods bid up, but then others down; no hoards to draw down and if were, why does greed mean spending them?; desire for higher living standards *reduces* prices, not raises—more production.

E. The Meaning of Inflation

1. The alternative theories confirm the quantity theory of money: whole problem of inflation in government's expansion of M, which causes more D.

2. Hence, definition of inflation as: *an increase in the quantity of money caused by the government*, or, equivalently: *an increase in the quantity of money more rapid than the increase in the quantity of gold and silver*.

3. This definition explains all the symptoms of inflation:

a. A sustained significant rise in prices (without material civilization disappearing).
b. A rise not only in the general price level but the whole range of prices.
c. Debtors gaining at the expense of creditors.
d. High nominal profit and interest rates.
e. A low demand for money for holding.

4. This definition shows how to stop inflation: stop the government from creating money in excess of gold and silver reserves.

5. Critique of definition of inflation as rising prices:

See points 1 - 4 under (A) above plus the fact that this definition makes no distinction between higher prices due to more D or less S—hence no ability to explain *all* the symptoms of inflation described under 3a. - 3e., above.

6. Difference in definitions is as important as right or wrong understanding of a disease: know what it is that produces all the symptoms and what needs to be dealt with to stop them versus attempting to deal directly with an isolated symptom.

F. The Deeper Roots of Inflation: Connection of Inflation with Budget Deficits

1. Deficits not inflationary if financed by selling bonds to the "public"— i.e., private individuals and non-bank corporations; here just demand diversion: government spends instead of private borrowers, who are deprived of the funds the government borrows.

2. But bankruptcy at end if such borrowing a regular policy.

Further problems with deficits: capital diverted to consumption—economic progress slows or is reversed; rising tax burden to service debt further contributes to process of decline; private consumer borrowing also disrupted—e.g., the mortgage market; for these reasons, and others (i.e., incompatibility with principles of representative government and creation of class of public annuitants supported by others' industry), long-standing opposition has existed to public debts (see Adam Smith, *Wealth of Nations,* chapter "Of Public Debts"—also von Mises, *Human Action,* pp. 224-28).

3. If the government had no ability to create money, then, in weakening the government's credit and threatening bankruptcy, borrowing from the public would actually be *deflationary:* under a fractional reserve banking system in which government debt serves as part of the assets of the banking system, it would be a threat to the quantity of money; also prospect of government bankruptcy would lead to rise in demand for gold and its exportation.

4. What makes government deficits inflationary is the ability to finance them by the creation of new and additional money.

This exists today at the Federal level (but not at the state or local level); hence Federal deficits are inflationary; mechanisms of money creation in connection with deficits already shown: create deposits and reserves, on basis of which banking system can create still more money in purchase of additional government bonds or in granting private loans.

5. Ability to create money makes it impossible for Federal government to go bankrupt in the technical sense—always has money available to pay its debts, and also raises its tax revenues in the process (at least absolutely and often relatively, as well); as far as debt held by Federal Reserve (central bank), even payment of interest is nominal, since most of it is turned back to the treasury.

Even though it can't go bankrupt technically, the government has probably long been bankrupt in the sense of being unable to repay its debt *in the same purchasing power in which the debt was contracted.*.

6. Inflation possible without current deficits in the government's budget—e.g., Fed can buy up existing government debt and thus create reserves and deposits; also, within—fairly narrow—limits the banking system might expand fiduciary media somewhat further under supporting framework the government has provided, but soon a problem of need for more reserves and more currency in circulation, which can come only from the government's creation of additional standard money.

7. *The essential element in any major inflation is government's creation of new and additional standard money.*

8. Desire for deficits implies opposition to the gold standard, since a gold standard would make bankruptcy the price of deficits, because it would deprive the government of the ability to create money and thus bail itself out; deficits unlikely under representative government where the price is this high; no end to deficits until the government loses the power to create money; proposals for constitutionally balanced budgets make avoidance fairly easy and could be evaded.

G. The Motives for Deficits and Inflation

1. To foster the view of government as Santa Claus—apparent free benefits from government. Cost, in form of rising prices, not seen as connected—blame shifted to business. How public thinks of government even now. Government vastly larger because of its ability to inflate—benefits seen, but costs not.

2. To be able to finance wars, as well as the welfare state, without the public being aware of the actual cost.

3. The belief that deficits and inflation are necessary to prevent or combat unemployment, which is the essential teaching of Keynesian economics; this belief provides major reinforcement for the free benefits idea: the bene-

fits are allegedly paid for by the elimination of unemployment, and much more besides—via the “government spending multiplier”.

4. The belief that creating money and lending it out is equivalent to creating additional capital and lowers the rate of interest—the businessman’s version of the welfare state.

5. Deeper explanation of most of these points is *the influence of the socialist ideology.*

a. Continuing expansion in size of government is movement toward socialism. Also view of government as Santa Claus conforms to socialists’ belief that the individual is helpless and that the government is all wise and all powerful.
b. A hostility to profits and interest—Keynes’ “euthanasia of the rentier”—also underlies the desire for credit expansion and the reduction of the rate of interest; but even without this, the desire for credit expansion manifests the socialist ideology insofar as it is a desire for a “free benefit.”
c. The unemployment problem also is largely an indirect result of the influence of the socialist ideology, for the labor legislation that causes unemployment is the result of the influence of the exploitation theory.

H. The Further Effects of Inflation

1. The growth of government under the influence of inflation-financed deficits and the free benefits idea.

2. Greater frequency and duration of wars in the belief not only that they do not have to be paid for, but are an actual source of prosperity.

3. Increased hostility to profits and interest because of the increase in nominal profit and interest rates, while the public suffers.

4. Price controls—as a method of controlling inflation.

5. Relative wealth and income effects:

a. People with fixed assets or on fixed incomes; the hypocrisy of helping the poor with inflation-financed programs.
b. The problem of lags and of incomes slow to adjust—an important deficiency of price indexes.

6. Effects on saving and capital accumulation.

a. Reversal of safety—traditionally safest investments made the least safe in terms of purchasing power; what purchasing power of the dollar made to depend on; risk effects on the average person: save less, hoard gold and silver, invest less efficiently—e.g., buy house on credit; at the same time enhanced speculative opportunities for the very nimble in commodity, real estate, and possibly stock speculation; diversion of efforts from productive work to artificially induced speculative activity.
b. Tax effects—recall the inventory case; now the depreciation case.
c. The prosperity delusion of inflation.

i. Of stockholders in above type case.

ii. Poverty coverup provided by seeming interest incomes.

iii. Wage earners’ lagged idea of purchasing power and consequent overconsumption.

d. Malinvestment—wasteful use of capital—stemming from artificially low interest rate.

i. Mises on false appearance of capital available for more capital intensive projects.

ii. Low interest rate relative to rate of profit: wasteful inventory accumulation.

iii. Low interest rate relative to rate of price increases: wasteful housing and real estate investment; potential for wasteful investment in anything, the stronger inflation becomes.

iv. Discrimination against long term investments, as in above machine example: if allow for rise in replacement cost, means higher prices or lower dividends now, before much of the inflation; which discourages such investments.

Note: in reducing the productivity of existing capital goods malinvestment further reduces or restricts the supply of capital goods, because the capital goods of the future are the products of the capital goods of the present.

e. The abstraction (withdrawal of wealth) effect: spenders of the new and additional money draw goods out of the system without putting goods in to earn the money they spend; thus corresponding loss to producers; loss of capital if new money spent preponderantly by consumers; probable malinvestment to extent spent for business purposes by firms not otherwise able to attract funds.
General consequences.

i. All five effects operate against capital accumulation.

ii. The reversal of safety, tax, malinvestment, and abstraction effects also operate to reduce the real rate of return on capital as well; reduction in real r comes in conjunction with *less* capital formation, not abundance of capital as advocates of credit expansion believe.

iii. Implication of gains of debtors less than loss of creditors—net reduction in real rate of return on investment as such.

iv. Impairment in growth of productivity of labor as the result of less capital formation because lower relative production of capital goods and less efficiency in their use—so real wages held down or reduced; real wages also held down because demand for labor depends on savings, whose growth is retarded relative to growth in consumer demand and rise in prices.

7. How inflation, especially in the form of credit expansion, sets the stage for standard, deflationary-type depression.

a. Raises V—so superinflates demand. Higher V sustainable only so long as inflation continues. May even need to accelerate. (Stabilization of V means slowdown in rate of increase in spending and sales revenues, hence reduction in monetary component in rate of profit. Hence profit squeeze in face of prevailing high interest rates.) Also, cash holdings run down in expectation of continuation of same or greater rate of growth in sales revenues. If M fails to accelerate, then profit squeeze and cash shortage develop.
b. Inflation (credit expansion) encourages debt by making rate of interest low relative to rate of profit and to rise in prices—raises ratio of debt to incomes and asset values already superinflated by rise in V.
c. In the ways shown under point 6, above, it undermines real capital and thus availability of real credit.
d. And as part of (b) and (c), above, it encourages investments whose profitability exists only because of inflation.
e. Because of all this, if inflation stops, slows down, or even fails to accelerate sufficiently, both a profit squeeze and a “credit crunch” develop. The latter occurs because capital has been diverted to projects whose profitability in whole or in part rested on inflation and the growth in sales revenues it inspired, and on the low rate of interest relative to the rate of profit that it caused. That capital is now not available. The diversion of capital shows up in the fact that in the absence of sufficiently large fresh doses of credit expansion, existing capital funds are made inadequate by the rise in wages and materials prices caused by initial injections of new money. This creates the potential for insolvencies and bankruptcies: surge in credit demand, to carry on business at higher wages and materials prices, and reduced credit supply, as the same cause makes funds more urgently required internally, leading suppliers of funds to supply less or themselves become demanders of funds. This situation makes some refinancings impossible, with the result that some firms can’t pay debts. Further result is a sudden need for cash by creditors whose own solvency is threatened because debtors can’t repay. Consequence is that V starts to fall, accompanied by inventory and other asset liquidations to raise cash. Sudden losses as investments whose profitability was based on inflation are no longer profitable; nominal profitability of all investments reduced by slower growth in D; all can be turned into losses by drop in D.
f. Revenues, incomes, asset values now stable or declining with huge debt incumbrance based on expectation of their rising—result: many debts not payable; further results: further credit tightening and drop in V—calling in of doubtful loans, need to raise cash as debts constituting one’s assets go bad, while the debts constituting one’s liabilities remain firm.
g. Bank failures as too many business and consumer debts go bad; this means actual *reduction* in quantity of money—deposits and notes of a failed bank lose their money character.

h. Less M further reduces spending and operates to reduce V further, thus compounding the problem—i.e., more business failures and still more bank failures; process like a row of dominoes falling over; ultimate stopping point: reduction of M to standard money; process descriptive of early ’30s, with successive waves of bank failures.

8. Unemployment.

a. Unemployment of depression and deflation due to inflation, because they are the result of inflation.
b. Inflation the preventive of unemployment only in the sense that more drugs are the preventive of withdrawal symptoms for an addict; no unemployment without inflation if don’t start the inflation in the first place.
c. Inflation a cure for unemployment only in context where not necessary—i.e., if no unions, etc., and so wages could fall and eliminate unemployment that way—or a very limited cure in context where unions showing restraint because of existing large scale unemployment and fear of adding to it.
d. If wages not free to fall and so eliminate unemployment that way, inflation will also not eliminate it—wages start rising with rise in demand, because of

i. Removal of threat of greater unemployment.

ii. Red flag of higher nominal profits produced by rising demand.

iii. Rising prices of goods in limited supply and then rising prices because of rising wages.

e. Inflation a direct cause of unemployment insofar as it ultimately leads wages to rise more rapidly than demand—in anticipation of price increases over the life of employment contracts—and insofar as it brings about a fall in real wages which labor unions are unwilling to accept: i.e., the problem of the declining productivity of labor and the failure of the demand for labor to keep pace with the demand for consumers’ goods.

9. Inherent accelerative tendencies of inflation, capable of culminating in the destruction of money and the division of labor; basic problem: government has the power to expand M; use of that power creates problems whose apparent solution is still more rapid expansion of M.

a. Continued growth of welfare state and deficits, with inflation to finance the deficits:

i. Natural philosophical basis of growth in welfare state.

ii. Help victims of previous extensions of welfare state.

iii. Decreasing real revenues of the government.

iv. Lags in tax collections.

b. Accelerate to paper over credit crunches and so prevent recession or depression.
c. Recessions as inflationary fueling periods—more rapid money supply expansion to prevent recession from turning into depression; then, when clear depression avoided, money comes pouring out.
d. Possible acceleration to make good general ravages of capital—e.g., an inflation-financed “reindustrialization plan.”
e. Adoption of escalators—indexing.

i. Wages to cost of living; multiply price increases; cause larger unemployment or more rapid increase in M to ratify them.

ii. Tax rates, depreciation.

iii. Social security, government bonds.

Government has smaller revenues and larger outlays as result of (ii) and (iii) and thus is likely to create more M.

f. Acceleration on account of interest: when rates rise high enough to protect creditors, they impoverish debtors, creating demands for more rapid inflation to enable debtors to pay; then creditors losing again; process repeats itself until creditors realize no interest rate in paper money is sufficient; then destruction of

credit; chance for quantum leap in inflation, with government creating money to make up for loss of private credit.
g. Acceleration on account of wage increases: every time wages rise more rapidly than the demand for labor, government must either allow unemployment to develop or accelerate the increase in the quantity of money; then wages rise still faster.
h. Accelerate to avoid profit reduction due to stabilization of V.
i. Continuous acceleration of inflation leads to destruction of money: becomes unacceptable when people know they must lose by taking it; then, possibility of no money; then no significant division of labor, no modern economic system.

I. The Current State of Inflation

1. Inflation and the stock market boom.

2. The fear of renewed inflation psychology.

3. The impending choice: will the government be willing to allow another major recession to develop to prevent this renewal?