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I•N•F•L•A•T•I•O•N

It's In The Bloodstream

by Don Paarlberg

➢ Before the twentieth century, inflation was more or less sporadic. There were intermittent episodes of runaway prices, superimposed on a general upward tilt in prices. We are now in the Age of Inflation; inflation has become a way of life. The public focuses particularly on short-term price changes, but tends to ignore how these changes accumulate over time. In fact, inflation has become worldwide and has an overwhelming effect on economic behavior. If societies are to make a break from inflation as a way of life, the first thing to do is to identify the major reason for changing prices. It is the money supply. It is a syndrome of denial to repeatedly attribute price fluctuations to other causes.

he accompanying chart shows the wholesale price level of the United States for the past 200 years. It is taken from my forthcoming book titled *Inflation.*

Why would I, an agricultural economist, write a book about inflation, considered to be the turf of monetary theorists? Because I am convinced that, contrary to popular belief, the major economic events which affected agriculture during the past sixty years were caused by monetary factors rather than, as commonly believed, by surplus and shortage of farm products.

The Thirties

During the Great Depression, the volume of money in circulation in the United States declined by one-third; since the volume of money "drives" prices, prices declined. Prices of U.S. farm products fell 56 percent. The Depression was worldwide; prices fell, whether farm or nonfarm, whether scarce or in surplus, in every country for which price data were available. World prices declined an average of 50 percent, an event which could hardly be attributed to a surplus of farm products in the United States. In fact, total agricultural production in this country during the first five years of the Great Depression was 2 percent less than during the five preceding years.

Contrary to popular belief, the major economic events which affected agriculture during the past sixty years were caused by monetary factors.

Farm people knew that, other things being equal, high production meant low prices and reasoned that because prices were low,

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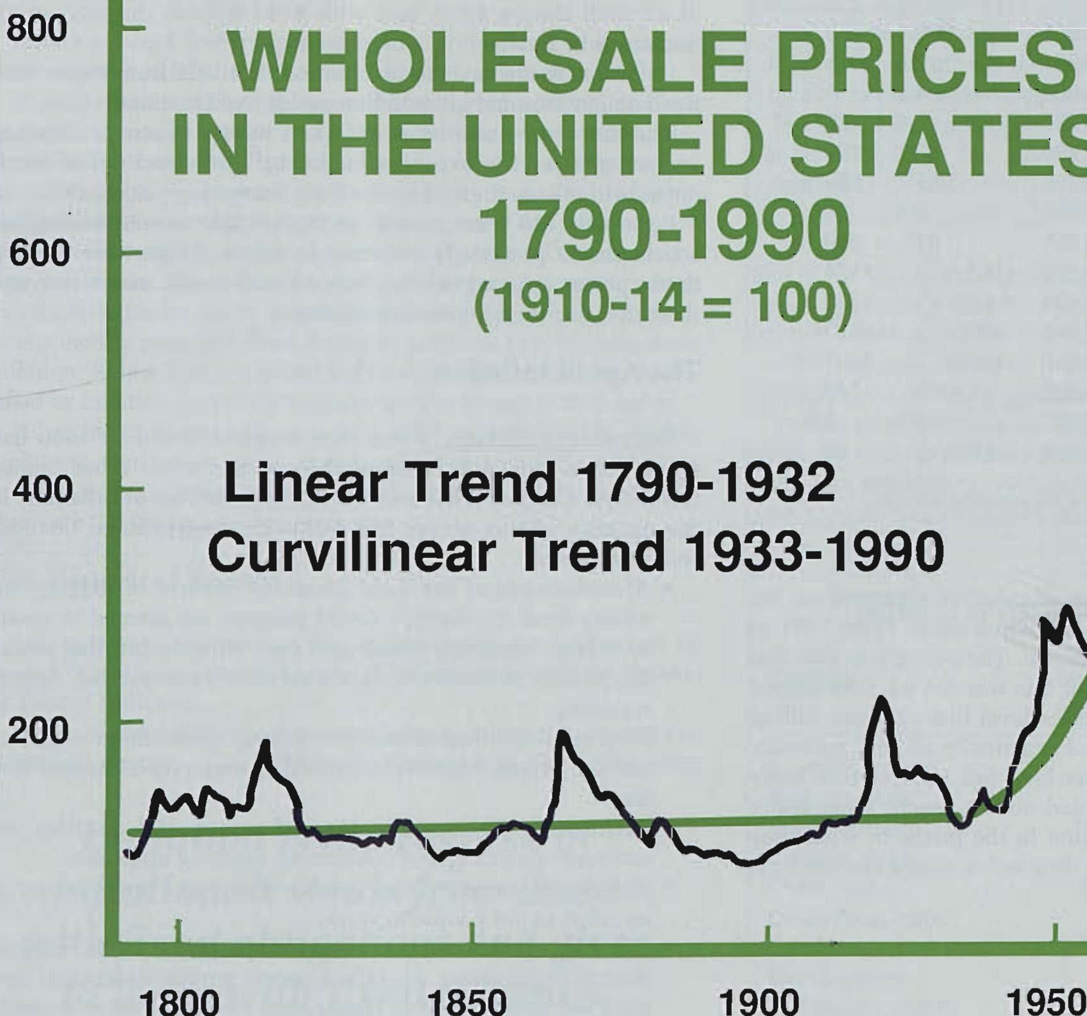

production must be excessive. But the overwhelming fact was that other things were not equal; the supply of money plunged downward, pulling farm prices down with it. Farmers didn't look at the statistics on production, and they didn't understand the mystery of money. They wanted to believe that surplus was the problem and judged it so. Their legislators accepted the verdict. Such is the power of belief, however, ill informed. So we launched the Agricultural Adjustment Administration to reduce output and set ourselves up in the crop-control business for the next half century.

Having boosted prices above the equilibrium level, we induced excess production and reduced consumption, creating a surplus, as any student of Economics 101 could have predicted. The diagnosis that we had a surplus became self-fulfilling.

The law embraces the money illusion. It writes "Paid in Full" across the face of a loan that has returned to the lender only half the real value of what was borrowed.

The Seventies

Another big agricultural event was the euphoria of the seventies when farm product prices more than doubled, an event popularly attributed to a food shortage. Actually, American farm output rose an amazing 32 percent during the decade. A rising general price level was at the root of the matter; it rose two and a half times, carrying up virtually all prices including prices of farm products, as a rising tide lifts all boats—except those that have sunk.

The Eighties

Then came another roller-coaster experience. The government, alarmed about inflation, boosted the interest rate, reduced the

Table 1 – Inflations of History

	Dates of inflation: Beginning	Dates of inflation: End of upsurge*	Commodity price index at end of upsurge (index on beginning date = 1	Annual % rate of increase
Ancient Rome	150	301	200	5.6
Black Death	1348	1351	2.4	5.8
Spain	1501	1600	4.2	1.5
John Law	1717	1720	2.0	26
American Revolution	1775	1780	32	100
French Revolution	1790	1796	285	157
U.S. Civil War, North	1861	1864	2.1	28
U.S. Civil War, South	1861	1865	91	209
Germany	1910-14	1923	$143(10^{10})$	1174
Russia	1913	1924	$171(10^{8})$	752
Hungary	1945	1946	$400(10^{25})$	$4(10^{25})$
China	1937	1949	$126(10^{13})$	1451
Bolivia	1972	1985	$103(10^{3})$	143
United States	1933	1987	7.7	3.8
Brazil	1937	1988	$800(10^{7})$	56

*Most of these inflations were not concluded at the end of the upsurge.

amount of new money coming into circulation, slammed on the brakes, and threw farmers against the windshield. From 1981 to 1986, farm product prices fell 11 percent. The perception was that surplus conditions had returned, but this was not so; farm output actually fell 6 percent. It was the price level that changed, falling 14 percent, carrying down prices of practically all raw materials including farm products. As the price level fell, some sunken boats became visible. Others were stranded on the beach. What really hurt farmers was not just the decline in the prices of what they produced; it was the excessive debt they had acquired and the high interest rates they were paying.

The Money Illusion

At fault in the misunderstanding is the widely held money illusion. This is the belief that the dollar has constant value, the same today as in the past, and the same as it will be in the future. This belief is obviously wrong, as an examination of the chart will show.

Inflation is the world's greatest thief.

The law embraces the money illusion. It writes "Paid in Full" across the face of a loan that has returned to the lender only half the real value of what was borrowed, and it forecloses property on which the full real value of the loan has already been repaid.

It is as hard to build a financial structure with a dollar of changing values as it is to build a house with a rubber yardstick.

Jekyll and Hyde

Inflation is the world's greatest thief. It extorts more real wealth from the public than do all thieves, looters, and embezzlers combined. Inflation, a Jekyll and Hyde character, is also the world's greatest benefactor. It transfers more real wealth to the debtor class (those who have borrowed money) than do all charities, contributions, and donations put together provide to poor people and others in society.

If this seems incredible, consider the facts. The total debt, public and private, in 1988 was $6.5 trillion. On this amount of debt an inflation rate of 4 percent per year (the average of the past half century) in 1988 is equivalent to a transfer of $260 billion from lenders to debtors. Compare this with $4 billion, the total amount of all theft during 1967, and with $154 billion, the total of all donations in 1984.

Deflation is the reverse of inflation. It steals from those with fixed obligations and gives to those with fixed incomes.

The monetary authorities are quite happy to accept shortage and surplus as the explanation for inflation and deflation. It appears to relieve them of blame for a fluctuating price level.

For nearly 140 years prior to 1933, the chart accompanying this article shows practically no trend in prices. There were fluctuations; prices approximately doubled with every major war and thereafter declined to prewar or lower.

The Age of Inflation

Beginning with 1933, prices rose irregularly, and by 1990 had increased to almost nine times their earlier level. What caused this abrupt change? What launched us into the Age of Inflation? In the opinion of this writer, the following institutional changes were responsible:

- *Abandonment of the Gold Standard:* instead of digging our money from the earth, a costly process, we learned to create it, in large amounts, at near zero cost, with the printing press.
- *Keynesian Economics:* this new idea rationalized deficit spending.
- *Growing Debt:* debt is onerous to bear. Both the government and the private borrowers learned to repay with cheaper dollars.
- *Attitudinal Changes:* instead of saving and waiting, we turned to spending and consuming, pushing up prices.
- *Full Employment Policies:* we overstimulated the economy in an effort to put people to work.
- *The Rise of Particular Interest Groups (PIGs):* with Political Action Committees, specific interest groups demanded and received more benefits than could be supplied at a stable price level; with inflation we appeared to confirm the benefits, but by inflation we reduced the real value of each claim.
- *Government Itself:* public officials found that, contrary to popular belief, when they opted for inflationary policies, they were returned to office.

These institutional changes, which produce inflation, are deeply imbedded in the economy and the prospect of dislodging them appears to be minimal. Inflation is in the bloodstream; short of a major transfusion, henceforward we can expect the price level to be tilted upward.

One thing to remember. Despite the likelihood of continued general inflation, there can be short-run periods of price decline that can wipe out the person who bets on inflation. This we found with a vengeance during the 1980s.

Restraining Inflation

If we were serious about curtailing inflation, we would need to effect the following policy changes:

- Reduce the rate of growth in the money supply.
- Check the growth of debt.
- Tax ourselves adequately.
- Give the President the line-item veto.
- Abolish Political Action Committees.

- Include price stability as an objective in administering the Employment Act of 1946.

It will be said that these things are difficult to do, and they are. But until and unless we do them, we have no legitimate basis for complaining about inflation.

Coping With Inflation

Inflation is not just a macroeconomic problem; it is at least as much a problem for the individual. How can a person cope?

If people are wealthy, young, ambitious, venturesome, anxious to pass on goodly estates and able to withstand temporary setbacks in incomes, such people should invest in enterprises in which they have competence. Real property is a good inflation hedge. Common stocks, though variable in price and earnings, are likely in the long run to ride the inflationary trend. One should be wary of bonds, life insurance, and certificates of deposit, which pay back dollar for dollar and fail to reflect inflation.

The elderly poor and those living on pensions can do little about inflation. At best they are forced to live within their pensions, diminished by inflation, and cannot expect to leave money to their heirs.

Admittedly, there is every combination of age, wealth, health, ambition, venturesomeness, and family responsibility. And, how to cope with inflation is an intensely personal matter. However, these are the general recommendations.

The Historical Record

Inflation is not limited to the United States nor to the last 60 years. There have been instances of inflation throughout history, as Table 1 indicates.

Some of the inflations were prodigious, especially during the twentieth century. The inflation in Germany in 1923, if it were shown on a conventional page-sized chart with an arithmetic scale, would have a peak two million miles above the top of the chart.

Deflation is the reverse of inflation. It steals from those with fixed obligations and gives to those with fixed incomes.

The one overwhelming perception that comes through from this historic review is that the volume of money is critical to the behavior of the price level. Inflation occurred when the supply of money was unduly expanded—as with gold coins, which were clipped, sweated, shrunk and debased in Ancient Rome; as with silver which greatly increased in volume in sixteenth century Spain, as in eighteenth century France; as with wampum in Colonial America, greenbacks during the American Civil War, and monetized government bonds in the United States today.

Deflation is associated with a shrinking supply of money, as we saw after the American Civil War and during the Great Depression.

If the monetary authorities wish to have a reasonably stable price level, they can do no better than to discipline the supply of money.

Inflation, when held to an annual rate of less than 10 percent (one digit), had a stimulating effect on the economy. If it crept up to the multiple-digit level, all kinds of disruptions occurred and public apprehension regarding inflation was validated.

Helped by a moderate rate of inflation are the productive sectors of the economy, chiefly businessmen and farmers. Helped by deflation are the salaried classes, those whose incomes are administered, and those on pensions and annuities.

With inflation, laboring people have found more jobs, but historically their hourly wages have lagged.

People in subsistence economies, who lived largely outside the exchange economy, were little affected.

A chief obstacle to restraining inflation is the fact that, on balance, people like a certain amount of it.

Prices in 30 Countries

Wholesale price increases from 1937 to 1988 were computed for 30 countries, with 1937 as a base. The 30 comprise all countries whose price series were continuous, or nearly so, for the 52-year period. The source was the *United Nations Monthly Bulletin of Statistics*. Eighteen have unbroken series. The unweighted geometric average increase for the 18 countries was an amazing 79-fold. Switzerland had the lowest amount of inflation, in which country prices nevertheless increased by a factor of about four. The United States was the next lowest, with prices increasing by a factor of about six. Table 2 reports price increases for the 30 countries.

Table 2 – Inflation is Worldwide

Country	Multiples of wholesale price increases since 1937 [1]	
Australia, pound	25	
Belgium, franc	11	
Brazil, cruzeiro	113,000,000	
Canada, dollar	9	
Chile, peso	26,400,000	
Costa Rica, colon	64	(to 1985)
Denmark, krone	14	
Egypt, pound	28	(to 1986)
El Salvador, colon	5	(from 1957 to 1985)
Finland, markka	124	
France, franc	132	
India, rupee	26	
Ireland, pound	12	(to 1976)
Israel, Israeli poun	372	(from 1963 to 1983)
Italy, lira	552	
Japan, yen	575	
Mexico, peso	391	(to 1985)
Netherlands, guilder	10	
New Zealand, pound	25	(to 1987)
Norway, krone	14	
Portugal, escudo	52	(to 1986)
South Africa, S. African pound	9	(to 1979)
Spain, peseda	98	
Sweden, krona	17	
Switzerland, franc	4	
Thailand, baht	85	
Turkey, Turkish pound	2090	(to 1987)
United Kingdom, pound	24	
Venezuela, pound	17	(to 1987)
United States, dollar	6	

[1] In terms of their respective currencies, 1937 to 1988.