CHAPTER 5

THE NATURE OF INFLATION

Inflation, like sentiment, is a word capable of two meanings: one coloured, one colourless. Both meanings refer to a state of affairs in which money becomes relatively more common than the things on which money can be spent at ruling market prices.

The colourless meaning of inflation refers to the condition of a country when the general price level—the average of all prices—goes on rising from year to year over a lengthy period. That is, the purchasing power of its money is falling. Its currency is depreciating as against the value of goods and services. Such a condition can come about from many causes. Wars and pestilences cause it, like the Black Death of 1348 or the World Wars of 1914-18 and 1939-45, which destroyed people, productive capital, and their products but left the same, or greater, amounts of money in circulation. Interruption of normal supplies of goods and services can cause inflation, as in a besieged city or beleaguered country—Paris in 1870-71, Britain in the World Wars—when the supply of money stays up or even rises farther, while the supply of goods on which to spend it is reduced.

New discoveries and exploitation of gold and silver deposits can cause it, as in the case of the sixteenth-century American dominions of Spain, and of Californian, South African and Australian gold last century. New financial methods can cause inflation, like the printing and use of banknotes, or the use of bank credit over and above the money value of the coin and bullion (gold and silver) in the banks—as in Britain, Holland, and other advanced countries between 1660 and today. All of these causes, however, operate accidentally or incidentally upon the supply of money in question.

The coloured meaning of inflation, on the other hand, refers

to the condition of a country when the continuous rise in its general price level—the depreciation of its currency, the loss of its money's purchasing power—stems directly from *deliberate* expansion of the flow of money and credit by the country's financial authorities, at a faster rate than the flow of things on which money and credit can be spent. This cause of inflation is political. It is a deliberate act of policy whether it is positively willed by the monetary authorities, or merely negatively permitted by them because they cannot, do not want to, or fear to, stop it. Inflation as an act of policy is never incidental or accidental. It never operates upon the supply of money and credit from outside—like wars, plagues, new supplies of monetary gold, interrupted communications, or new methods of financing. The more modern, usual, familiar, and by now derogatory meaning of the word inflation is this second coloured meaning. It is that which is used when the relatively more rapid supply of money than of the things on which it can be spent at ruling market prices is due to an act of policy by the monetary authorities. It is that political meaning of inflation with which this book is concerned.

Both kinds of inflation, both rises in the general price level which result from 'more money chasing the same amount of things', are diminished, modified or offset by expansion in the flow of things for sale. When famine is overcome by a new bumper harvest, prices fall. ('Here's a farmer that hanged himself on the expectation of plenty.'[1]) Populations increase after plagues or wars. War damage is made good. Shortages are overcome by investment of new savings in new productive capital equipment. The application of new scientific techniques makes two blades of grass grow where one grew before, and a new machine or method turns out more than the old one which it replaces. Human skills increase and multiply. Communications improve and swell the volume of things and services exchanged by trading. So the expanded flow of goods and services offered for sale in the markets tends to catch up with, and match, the expanded flow of money offered in those markets, and to offset inflation.

Expansion of the supply of money and credit thus carries within it a moderating influence—as long as it is kept in step with expansion of the supply of goods and services. Even if the

[1] Macbeth, II, 3.

year-to-year rise in the general price level goes on at something between 1 and 2 per cent, individuals and companies will—for a time—still save and invest in new productive capacity which raises productivity and offsets inflationary effects; will still lend or borrow; will still abstain from spending their current incomes or profits up to the hilt; will still look to a future in which money will still have some purchasing power, some value, and therefore some reliability as a measure of all other costs and values and as a store of wealth. In that case the new machines and productive capacity made possible by the new savings and investments will continuously come into operation. So will the applications of new techniques and methods, and the work and skills of new men and women as population grows. Output of goods and services will rise to match the earlier inflationary rise in the flow of money, and the bigger flow of goods and services to markets will therefore tend to diminish or control the inflation of all prices in those markets.

Long Run and Short Run

The movement of the general price level in a country through a fair period of years is therefore the outcome of a shifting relationship between two flows: the flow of the money offered in markets for goods and services, and that of the goods and services into those markets in exchange for the money. If the flow of money into markets expands in that period more than the flow of all things on which it can be spent, inflation of prices, and therefore depreciation of the currency, follows. The purchasing power of money falls. If the converse happens, and the flow of goods and services offered in markets expands in the period more than the flow of money, deflation of prices, and therefore appreciation of the currency, follows. The purchasing power of money then increases.

According as one or the other, or neither inflation nor deflation, occurs, so will all income-receivers—individuals, companies, institutions, the State itself—decide whether to spend all their incomes, save some or much or little or none, borrow or lend at short or long term, incur or reduce debts, invest in new productive capacity for a long time or just 'stay liquid' with ready cash available and so 'buy time'. All these possible actions depend upon their actors' attitudes to money's worth, to the trend of

prices, and therefore to the trend in the real purchasing power of money.

Few people realize how important in economic affairs are the views taken of the trend in the value of money by potential savers and investors, both individual and institutional. Their present view of the economic future; their comparisons of the worthwhileness of present spending on goods on the one hand, and of the saving and investing for a possible greater gain in the future on the other hand; their belief or disbelief in a continuation of economic growth at past and present rates or of inflation or deflation—all these attitudes elbow and jostle each other in the various markets for money, credit and capital. They swell or shrink supplies of each kind of purchasing power, and they overflow or fail to come up to the demands for each.

The various rates of interest react and are determined for varying periods accordingly: rates for long-term loans to match the volume of long-term investment in such big and durable capital goods as houses, factories, heavy machinery and installations, port equipment, schools, etc.; and rates for shorter-term loans to match individuals' and businesses' needs of day-to-day working capital, 'tide-over' credits, bank overdrafts, hire purchase advances, trade credit, etc.

All such financing of long-term and short-term needs is a recurrent, day-by-day necessity in a complex, modern, industrial society. The various rates of interest not only measure and reflect the varying pressures of potential borrowers' needs for finance and of potential savers' desires to invest. They also measure and reflect the worthwhileness of spending on goods immediately as against saving and investing *at all* (either at long or short term), and the worthwhileness of 'staying liquid' (*i.e.* not spending on goods immediately—saving, but *not* investing in anything for the moment) or investing only for a short term (*e.g.* in a building society, a savings bank, a bank deposit, a Government three-months' bill, etc.) instead of for a term of many years.

Thus the degree, duration, and rate of an inflation create in the minds of potential borrowers and savers, whether individuals or businesses, varying attitudes to the spending and saving of their existing money, their current purchasing power. If that current money, that currency, has been and is still losing its purchasing power at a fast rate due to a rapid inflation, it will be harder to

get people to tie up savings for years at fixed interest rates. Businesses will want more and more money as all wages and other costs rise—so will Governments—both to pay for fixed, long-term, capital assets (like buildings) and for day-to-day working capital (as wages and other costs and prices go on rising). But savers will not be so keen on saving and investing, unless they get a 'share' in businesses: a 'hedge' against depreciation; an 'equity' which will rise in value, and in yield of dividend, as inflation goes on. Since governments do not borrow by issuing shares—only by issuing IOUs at fixed interest rates—the financing of governments' needs in an inflation becomes increasingly short-term and difficult; and business 'equities' are preferred to governments' fixed-interest bonds. All rates of fixed interest rise. All dividend yields fall, as savers rush to buy business 'equities' as 'hedges' against currency depreciation, and so push up their prices on stock markets. As the prices of these ordinary shares rise, their existing rates of dividend show smaller and smaller returns or yields on the rising prices which have to be paid for them. There is a boom in ordinary shares, a slump in the price of Government bonds ('gilt-edged') and other fixed interest securities. This inflationary pattern has been repeated in the economic texture of one industrial democracy after another during the past generation of war and its aftermath.

The Inflationary Dilemma

The argument against inflation as a policy in a democracy rests upon two counts: first, that such inflation arbitrarily alters all demand and supply, and all values, without reference to economy or efficiency—which is an economic count; and secondly, that it arbitrarily alters all legal and other social relationships reared on the stability and continuity of such values—which is a sociological count. If it were possible precisely to foretell at any moment just what effects a given amount of inflation would produce in any given society, these two counts might fail, and the argument against inflation might fall to the ground.

Apologists for 'only a little one' might then point out, with some rough social justice, that a deliberately modest but steady and regular inflation would become absorbed into the daily *data* of a democracy: that it would be discounted in advance in all calculations; would become as taken for granted as the level of

income tax or turnover tax or companies' profits tax; and would therefore make no *real* differences or alterations to anyone or anything. But that would be to misconceive the whole point of inflation *as a policy*. As soon as an entire society accepts a given rate of inflation as a *datum* and discounts its effect in advance in all calculations of value, the government—the inflating authority which gets the prior benefits of inflation—must step up its rate, in order to secure such prior benefits of fresh inflation over and above what the entire society expected and evaluated in advance.

Like a baby, 'only a little one' quickly becomes a big one. If it were not so, society would indeed adjust to the expected rate. The government would then quickly lose any continuous gain or benefit from a regular, steady rate of inflation. Equally quickly, it would find itself again facing all the awkward dilemmas and decisions from which it had run away by inflating in the first place. So any inflation *as a policy* must grow by feeding on itself, on its own effects. To get inflationary advantages over everyone else in the society *as a set policy*, a government must inflate more and more. This cumulative, compounding nature of inflation compels inflating democratic governments to place more and more compulsory controls on the individual and corporate life and business of their citizens. Thus to secure inflationary benefits for the State as a policy a democracy tends to undo itself.

Economic knowledge and analysis are nowhere within sight of being able to foretell with any accuracy what the effects of a given degree of inflation will be. They can tell very roughly what will follow, but only in the broadest outline. Even then, the given degree of inflation must continue steadily for a fair time. One 'shot in the arm' will not have the same effects all through a social organism that continuous, increasing doses will have. The effects of 'one shot', once and for all, are hard enough to prophesy; but they can be gauged—as when young John Maynard Keynes told his mother he could double the length of every shopping queue in England simply by slipping an extra £5 note into every pay-packet on one Friday only. When governments of democracies—or any others—have recourse to inflation it is almost always an act of despair. It is seldom, if ever, 'one shot' once and for all. The effects of such deliberate, steady, continuous, compounding inflation are easier to foretell, but even then only in the broadest of outlines.

What Inflation Does

It is unnecessary here to do more than describe such outlines. First, all contractual claimants to fixed sums in the future are penalized the longer and the more rapidly inflation goes on; but workers at all levels of income can raise their money incomes. Those organized in trade unions or professional bodies or pressure groups can do so more easily than those not so organized. But the longer and more rapidly inflation goes on, the higher go all earned incomes in the existing brackets of income tax and sur-tax; so inflation takes more in tax from the better-paid, the more responsible producers. So, too, the State Treasury has a vested interest in a long or rapid inflation because it automatically spells 'buoyancy of the revenue'. Just leaving income taxes, sur-tax, and profits taxes where they are must result in higher tax yields, as the rising incomes in depreciating money push their recipients into the higher brackets of 'progressive taxation'.

In Britain in 1949 scarcely any ordinary weekly wage-earner could have imagined ever becoming liable to sur-tax, which begins—as forty years ago—at £2,000 p.a. But in 1959 quite a number of such workers were already paying it. And by 1969, if inflation were to proceed as in 1949 to 1959, one-third of all weekly wage-earners would be sur-tax payers. Consequently the course of inflation in democracies with 'progressive taxation' (and what democracies are without it?) is (*a*) increasingly to penalize responsibility and good management, (*b*) progressively to advantage the State's tax revenue, thus giving it an automatic 'hedge' against inflation, (*c*) relatively to benefit, and therefore to stimulate demands from, the best-organized pressure groups, and (*d*) to advantage the lower income-earners whose *money* incomes can rise farthest before getting into brackets of 'progressive taxation' where heavy income tax becomes payable.

Secondly, inflation therefore penalizes—like a secret, increasing tax—all claimants to fixed money incomes in the future: all pensioners, holders of insurance policies without any rights to 'with profits' bonuses, holders of *all* fixed-interest securities at medium or long-term (*e.g.* government bonds, industrial debentures, simple preference shares), landlords of real estates leased for medium or long terms at fixed money rents, recipients of annuities bought by lump-sum down-payments earlier, owners of patents or copyrights or other 'know-how' who have granted

royalties or licences at fixed money fees for medium or long terms, and beneficiaries of trusts, covenants, and other funds, the money income from which depends on fixed-interest securities of any kind.

The social tensions and stresses set up by inflation between all such claimants to fixed money incomes and all other income-receivers in a democracy are well known since 1918. Each government tries to alleviate them in its own way by granting 'reliefs': raising the State's old-age pension rates, for instance (but not privately-secured pension rates). But this leads not only to fresh tensions and injustices. It also leads opposition political parties to bid for the votes of the social groupings most aggrieved by the inflation: *i.e.* mainly those which are unproductive (the retired, dependent, or sick) and/or those hitherto unorganized. Thereupon new social organisms arise embodying those suffering most from inflation, organized for party-political as much as economic or equitable purposes.

The result is generally to import into democratic politics, by an inflation conceived as a policy to *avoid* awkward social decisions, such a doubly awkward set of dilemmas as would never have been willingly or wittingly incurred at the outset, had the government and its advisers only known what lay in the inflationary wind. Should the government be outbid for votes and change hands in the ensuing whirlwind, the incoming party will probably run away from such doubly awkward dilemmas by having recourse to further inflation, rendering them quadruply awkward. Thus the process of undoing democracy—politically, economically, socially—proceeds cumulatively.

Thirdly, however, inflation confers a 'hedge' or an outright capital profit on all holders of liquid capital funds, of movable assets like ordinary 'equity' shares, of freehold farms or houses in their own occupation, or of anything else *immediately* saleable or usable in any business sense. As the purchasing power of money depreciates, people and businesses 'get out of' money and 'get into' *real* values: *i.e.* they get rid of money, and of any rights to receive fixed sums of it in the future, and rush instead to acquire titles to a share in any economic activity which (like organized workers) can push up its prices to cover its rising money costs. So down go the prices of all titles to fixed money incomes in the future, and up go those of all titles to future money incomes

which can rise with the rising money value of trade and its profits. Up also go the prices of any durable object in general demand—a house, a genuine work of art, a diamond necklace—the supply of which is limited or difficult to expand quickly; for people rush to acquire such 'real values' in exchange for their increasing amounts of depreciating money.

Inflation against Society

These variable social effects of inflation interact. They are not independent variables. They are interdependent. People or associations entitled to fixed money incomes have their standards of life forcibly cut. They are forced to sell capital if they own it. Those who can push up their incomes in inflation, despite their liabilities to heavier income tax and sur-tax—*e.g.* those who are not yet in the highest income brackets, or those who can make even bigger trade profits, after tax, than the rise in money costs would warrant—buy the capital of those forced to sell it.

Most businesses are made highly profitable in paper money by inflation: they can pay their taxes—even if governments raise them, though they do not need to because of the abovementioned 'buoyancy of the revenue'—and all their rising money costs, yet 'plough-back' substantial net profits, and pay good dividends to shareholders. Other businesses and trades, especially those dependent on exports, may be badly hit; so may be their employees and shareholders. The interests of the old and retired are set against those of the young or middle-aged. Those of the unproductive are set against those of the productive. Those of the prudent 'truster'[1] who endowed trustees with his savings at fixed interest for long term in favour of beneficiaries in the future, and those of his beneficiaries too, are set against those of the quick 'in and out' operators who make virtue and profit out of *not* holding on to any money. The interests of all who save, contribute, build, and create for a long-term future are set against those dependent for profit on the highest 'velocity of circulation' of money. No one can trust money or government. Society and its once firm institutions begin to flounder in deepening flux.

So criticism of a policy of inflation from the social standpoint is not difficult. There can be no justice or equity in a *democratic* governmental policy which deliberately and arbitrarily injures

[1] *cestui que trust* is the legal term.

owners of one kind of savings and investment for the future (at fixed interest) and favours another (equities), which alters the terms of all contracts and other legal arrangements for property rights in the future, which does such things without public justification and explanation, and at arbitrary but secret rates of tax. The ensuing sense of injustice in many injured groupings of the society, the ensuing social stresses and tensions, rise with formidable, explosive force, the faster and farther the inflation goes.

The greatest single factor responsible for the rise of the Nazi movement to supreme power between 1923 and 1933 was the inflation deliberately pursued by the first democratic governments of the Weimar Republic. It created social tensions and discontents among the modest property-owners which Hitler and his helpers were easily able to capitalize. Much the same social tension followed deliberate inflations in Italy and Spain between the two world wars. In more recent times we have witnessed the foundering of the Fourth democratic French Republic and its supersession by a régime half-authoritarian, half-monarchical, in which parliament and representative government are reduced to symbols. The political systems supervening on democracies which have undone themselves by policies of inflation can better cope with the inflation and its effects, as now in France. But they generally do not. That does not invalidate the criticism of inflation from the social standpoint. Once done, the harm to social and political solidarity by a democracy's arbitrary alteration in all property rights is hard to undo.

Inflation against Economy

Criticism of a policy of inflation from the economic standpoint is even easier. Inflation causes an arbitrary 'windfall' distribution of inflationary profits, divorced from productive efficiency or productivity which are the normal sources of profit. Socialist governments of democracies should therefore be more anti-inflationary than any others, for they have always morally condemned both the private profit motive and all windfall profits to which the work of the recipients has contributed nothing: *e.g.* profits on buying and selling investments, profits on the rise in land or other real estate values due to the economic development of the community, etc.

But alas for principles in political practice! Socialist govern-

ments of democracies—for instance, in Britain, Sweden and Norway—have deliberately inflated as fast and far as any other; and while they have attempted to tax away windfall profits, they have not dared to tax them *all* away, lest the real capital equipment of the profiting concerns be rapidly eaten up by the inflation, and business failures and unemployment on a grand scale supervene. Even in inflation, therefore, Socialism has shown that ambivalent class-conscious attitude—confusing to friend and foe alike—which is best exemplified in Britain by its doctrinal opposition to the windfall profits of investors or business men alongside its political condonation of windfall profits for winners of football pools (in which the big winnings are in fact the small people's contributions). The flux of inflationary profits is therefore only an economic aspect of the social flux in all values and principles caused by inflation.

There are two other main criticisms of inflation's effects in the economic sphere. First, inflation interferes with people's normal calculations about present *versus* future values, about spending or saving, and about one kind of investment or another. By making the money measure itself alter all the time, it distorts the normally dependable structure on which businesses and individuals must found calculations of the comparative worthwhileness to themselves of possible economic actions. To offset inflation, to cope with it as an added factor in economic calculations which are complex enough without it, they must engage in economic courses which they would not follow if money were reliable, stable and sound.[1]

Secondly, businesses *must* make more profits in an inflation, in order to be able to replace their old capital equipment, when it is scrapped, with new and better kinds, but at much higher prices. The higher replacement costs must be covered by savings—either those of the business itself ('self-financing' by 'ploughed-back' profits) or those of individuals or institutions (*e.g.* insurance companies) making fresh savings and investments. In either case, governments *must* permit such savings in an inflation; else society's productive capital would run down, dragging employment and standards of life with it. So democratic governments get themselves into worse dilemmas the more they inflate. If they tax away more and more 'windfall' profits they themselves must

[1] See Chapter 4, p. 61.

steer them back into productive investment (which makes the society more and more Socialist, State-run, and totalitarian). Or they must leave those profits to the decisions of individuals, in which case—as inflation goes on—greater paper profitability will occur in businesses and undertakings which may increasingly retain those profits under their own control. New savings will thus only become available to existing concerns.

The 'hecticness' above mentioned, the distortions of values due to inflation, will thus import into all business decisions the overriding decision to defeat inflation itself. Hence disruptions of business decisions are added to the distortions of consumers' demands, as the distribution of more and more depreciating money throughout the society is itself distorted.[1]

Inflation against Growth

Of all inflationary distortions the subtlest, and possibly in the long run the most dangerous to the society, is that which disrupts the appropriate, normal, 'indicated' and requisite pattern of development and growth. The capital structure of a society at any given moment 'indicates'—implies in its very proportions—a logical, requisite pattern of further investment for both its maintenance (replacement of outworn assets or wear-and-tear) and development (extensions and expansions). This pattern is a kind of schedule through time-to-come: buildings and long-enduring assets falling due for replacement only slowly and therefore in small annual portions; 'younger' assets, like machines, falling due in greater yearly bulk; and special machines, or other capital assets for one short purpose, even falling due in two years or even less (50 per cent p.a. depreciation rate and even higher).

Inflation subtly saps this structure. It undermines confidence in savings and investment and in the future value of money. But it undermines it much more for long-term investment, less so for that at short term. Consequently the regular pattern, the logical schedule, of requisite investment ceases to be practicable. The schedule or pattern becomes heavily tilted towards short-term investments and more quickly turned-over profits in depreciating money. Longer-term assets suffer. Accordingly the entire economy gets disrupted in its production, distribution, consumption, and investment. And accordingly also the rates of development or

[1] See Chapter 4, p. 62.

growth of the economy in its component sectors—agriculture, industries, services, houses and other buildings, communications—go all awry, tilted towards the present and away from a remote future, or else tilted towards investment in assets peculiarly capable of benefiting from inflation, or capable of being quickly converted from one temporarily profitable use to another. Since inflation confers extraordinary 'windfall profits' on such shorter-term, quickly transferable, smartly 'in and out' uses of capital, it necessarily militates against a stable, steady, compounded rate of economic growth.

Yet a democratic society stands eminently in need of just such stability in its economic development in order to conserve its citizens' freedoms. A totalitarian one 'enjoys' (if that is the right word) a built-in instability of development anyway, matching its enforced rigidities, strains and stresses, and its sudden arbitrary alterations, 'according to plan'. Thus inflation as the policy of a democracy destroys the foundations for its own dependable economic growth.

No Two Kinds of Inflation

For a time there was a fashion to talk of two kinds of inflation: one due to sheer superfluity of money and credit put out by the authorities; the other termed a 'cost-push' inflation, due to upward pressures on money incomes from vested interests and groups whereof trades unions were chief. But it is a distinction without a difference. If the money and credit were not continuously available, if employers knew that they could not pass on rising costs ('cost-push') to consumers who could pay more, no amount of 'cost-push' from trades unions or other suppliers would gain such pushers any greater money incomes. All that would happen would then be the bankrupting, or other retirement from production, of the marginal employers in line after line of activity, with consequent unemployment of resources. Marginal consumers—unable and unwilling to pay higher prices—would leave some supplies unbought. Continuous inflation as a policy provides both producers and consumers with the extra wherewithal to pay an additional round of higher prices. Once that stops, the last round fails to sell goods and a limit is automatically put on further rises in costs, prices and money incomes.

A doctrinal dispute has arisen over this. Some political

economists say that a society will not grow at any reasonable rate without 'only a little' inflation. They point to what they call the stagnation between the world wars—omitting to notice the vast technical and other changes (*e.g.* in shipping, transport, housing) carried out in that period in America, Britain, Germany, etc. On the other hand some political economists take an extreme anti-State position, denying the State any use or duties or powers, and demanding a rigidly automatic monetary and economic system of *laissez faire*. Under such a system a world-trading society might through no fault of its own be subjected to fierce economic onslaughts and unemployment by the actions of other nations, and be denied the right to cushion or counter them. Moreover only the State can establish and supervise the legal and other conditions to make freedom of enterprise and competition effective.

Truth, as nearly always, lies in the middle between extremes. The modern democratic State has a duty to secure not the most rapid growth, but the most rapid *reasonable* rate of growth. It must be reasonable in relation to preservation of individual and corporate freedoms, to social and political stability, to availability of enough resources 'in reserve' to meet new situations and techniques and demands, and to the stability of all money values, costs and prices upon which calculations for the future must be made. Continuous inflation, carried as a policy beyond that point, will make hay alike of democratic society and growth itself. The State will then have to round on the trades unions and other pressure-groups, instituting a compulsory 'national wage policy', freezing people in jobs and lines of business, and generally undoing the democratic system of free worker's association, free consumer's choice, and free producer's enterprise. A democratic system can only function freely and for the good of all between the extremes of outright Statism on the one hand and outright *laissez faire* on the other. Under either extreme system, democracy and personal freedoms, the social responsibility of the strong to the weak, and the cohesion of modern society alike become impossible.

It is the task of democratic government therefore to avoid the inflationary extreme on the one hand (with its trend to totalitarianism) and on the other the anarchy of extreme *laissez faire*. That means reliance on up-to-date economic information, on expert analysis, and on courageous judgments and actions for the general good and against the partial vested interests and pressure

groups. These latter must squeal, as new techniques and unforeseen developments pinch them. But if a coherent, progressive, democratic society is to persist, they must never be allowed to get what they squeal for. The purchasing power of that society's money—the measure of all material values and their interrelationships by which alone growth itself is measurable—must be kept as stable, reliable and calculable as possible, no matter who squeals or for what.

There are other ways of cushioning and relieving the pinches of circumstance than by an indiscriminate, continuous inflation which confuses everyone and everything in a combined wage-push and cost-pull on all prices. Democracy's money should be as 'neutral' as possible. It cannot in the modern world be entirely neutral, *i.e.* utterly unmanaged and automatic like gold coinage before banknotes and credit were developed. But democracy's money should not be allowed to exert a persistently inflationary influence on prices *merely because inflation is official policy, i.e. an independently operating monetary factor in its own right.* Governments should strive to keep money to its normal role of a neutral measure—varying its supply only to preserve stability of prices and thus conserve its reliability as a measure. If they do this, we shall more accurately be able to gauge the pure effects of technical and other developments in an economic system, without any confusion due to monetary changes. And that will enable us to cope with them *apart from inflationary or deflationary influences.*

Anatomy of Inflation

The confusion between so-called 'monetary' inflation and 'cost-push' (or 'wage-push') inflation arises for understandable reasons. As we have seen, any inflation in any period must result from *the rate of flow of money incomes* increasing more than *the rate of flow of goods and services on which those incomes can be spent* (including in 'goods and services' and 'spent' the investment of savings in capital equipment). Thus, there is always a race going on between the two rates of flow in any country; and to bring them into balance, so that costs and prices become stable, is always a delicate and difficult task.

Technical progress, new equipment, and better methods of work are always pushing up the productive efficiency (or produc-

tivity) of all ingredients of production—more, naturally, in manufacturing, less in administrative, clerical, professional, and other 'service' occupations. So the year-to-year rise of productivity turns out more goods and services from much the same labour force, as the machinery and fuel and horse-power per worker (capital per worker) increases. This productivity rate therefore always offsets any inflation of money incomes. It varies from one country to another as capital per worker, technical know-how, and other conditions vary from country to country. In the United States, Britain, Sweden and Switzerland—countries relatively unscathed in the last war—the year-to-year rise in productivity per worker between 1950 and 1960 varied only between 1½ and 2½ per cent a year. In Germany, France, Japan and Russia on the other hand—countries in which conditions, for many reasons, were far different—it varied between 3 and 7 per cent a year. That is the anti-inflationary rate of flow of production.

The second inflationary rate of flow, that of money incomes, is determined at two sources. The first source is the State's, and Government's own spending, its tax-revenues, levies, charges and borrowings; for all State spending goes out to become somebody's income. The second source is the arrangements of incomes between private employers and employed, the self-employed, retired, etc. This is where the confusion between 'monetary' inflation and 'cost-push' or 'wage-push' inflation begins. People get into the habit of looking *only* at one source—that of the State's monetary activities—and calling any 'deficit financing' at that source 'monetary inflation'. Or they look *only* at the other source—commonly called the industrial front, but better called the private sector—and call any agreed pushing-up of profits and other earnings a 'cost-push or 'wage-push' inflation. Yet whether there is in fact *any* inflation going on at all depends on the result of three varying factors: first, the rate of flow of goods and services available to savers-investors and purchasers, dependent among other things on the rate of technical progress (increasing productivity); secondly, the effect on balance of all the State's activities in taxing, charging, subsidising, spending, and saving-investing; and third, and only lastly, what employers and employed can do in the private sector of the economy *after* their private stage has been set for them by the State and the other monetary and credit authorities (*e.g.* the banking system, hire-purchase firms, etc).

How Inflation Arises

Whether inflation *will* occur—whether the general price level will rise in any period—depends on the interaction of those varying factors. For example, prices need not rise at all, though the State spends more and wages and profits and all other incomes rise (say) by 2½ per cent in any year, if only over-all productivity also rises by 2½ per cent or more. The rate of flow of goods and services, on which the extra 2½ per cent of money incomes is spent, will also have increased to match the extra money incomes. Similarly prices need not rise though the State undertakes a lot more public works of a capital kind (*e.g.* highways, railways, housing, schools, hospitals, harbours) provided it can finance them by borrowing its citizens' willing and voluntary savings to that amount—or by forcing them to save it (as in Russia) or by extra taxation of its citizens to that amount (which *is* forced saving)—or provided that private enterprise reduces its own investment programme by the amount the State needs, and the existing savings then get switched from private enterprise to the State.

Inflation arises in any period when the total of money incomes is allowed, or made, to rise faster than the community is prepared, or allowed, to turn out all kinds of goods and services on which the money is spent. Accordingly it can be brought about by the State and other monetary and credit authorities alone, if they merely expand the flow of money beyond the flow of goods and services. It can be brought about by both the State and private employers and employed, if the State piles over-ambitious spending programmes on top of private enterprise's own programmes, and then finances the State's programmes not by borrowing real savings but by short-term borrowings (IOU's) or other 'deficit finance'. It will always be brought about if the total of investment in any period—the total of both State and private capital programmes—amounts to more than the savings (personal, by businesses, and 'forced' from taxpayers) available, and the gap is then covered by expanding credit.

Ultimately, therefore, the control of inflation involves trimming this total of capital programmes—*i.e.* investment of all kinds, State and private—to available savings of all kinds, whether voluntary or forced by the State (in Budget surpluses of tax-revenue). But citizens demand that the State and private enter-

prise should simultaneously push forward with ambitious modernization and other capital programmes. They also demand continuation of 'full employment' policies, development of under-developed countries overseas by new loans, rising wages and other incomes and thus their own consumption standards at home, more State welfare services, etc, etc. If the State is administered by timid or lazy governments, inflation seems the easiest way of meeting most people's—at any rate, most productive people's—requirements in the short run.

If such governments keep the flow of money and credit *ahead of* the flow of goods and services (productivity), the State's own clients and beneficiaries will get what they want (in money); employers will all make enough (paper) profits to cover rising wage and other costs and yet survive; trade unions will all get from employers what they push for (in money); and for that short run only the non-productive pensioners, retired folk, and other receivers of fixed money incomes will suffer from the inevitably rising prices.

But short runs become long. The longer inflation of this kind goes on, the more prices rise. The greater, then, become the inflationary problems; for it becomes increasingly difficult to control inflation. For example, individuals and businesses stick to their savings and profits or invest them only in their own concerns or in ordinary shares in private business, and refuse to lend to the State at long or medium term. That forces the State in turn to rely more and more on short-term finance for its programmes, which in turn increases the inflationary potential (the basis for the banking system's supply of credit). Again, trade unions and employers start to discount the rate of inflation—the rate of rise in prices—in their wage-demands and profits; which pushes costs and prices higher, and so outpaces faster than ever the rise in productivity. (While productivity rose at roughly the same rate in the USA and Britain between 1950 and 1960, the greater British inflation in that period pushed British prices up at 50 per cent more than the American rate of price-rise.) Technical progress and productivity do not stand a chance of yielding their best fruits once inflation has been allowed to become a built-in, long-run affair. They only stand their chance of doing so—of thus helping to maintain sound money and true costs and other values—if the Government, the State, and the monetary and credit authorities

first give them elbow-room in which to operate. That room can only be provided by sound currency itself, on which all calculations can be based. And that can only be provided by abjuring inflation as a policy.

Controls Over Credit

Among governments' instruments for producing or reducing inflation are what economists call 'open market operations'. Briefly these are purchases or sales of government 'gilt-edged' bonds or other longer-term IOU's in the market by a government's agents. Thus if the government's agents bid at prices attractive enough—*i.e.* at higher than market prices—they will get such bonds by pushing up their prices, and thus pushing down the annual yield of interest on them, which is pushing down the long-term interest rate. They will then be paying cash out to these bonds' former owners. The new cash will come from the government, who in turn secure it by issuing new short-term IOUs (bills) to the government's bankers, who in their turn create new credit against them for the government to draw on: *i.e.* new overdrafts, if you like. This process simply converts what was a long-term locked-up saving—a medium- or long-term government bond—into liquid cash. It increases liquidity. It lowers interest rates. It stimulates enterprisers to borrow, since the owner of the new cash must do something with it. If he merely buys another security, he merely passes on his cash to the seller who inherits the headache 'what to do with the cash?' At some point, with someone, the extra liquidity will be put to work: buying some goods and services, whether consumer's or producer's (capital) goods, and thus employing more resources—or calling more forth—than were till then employed.

That is an example of an 'open market operation' designed to expand a country's purchasing-power and economic activity. It is useful in a recession or depression when unemployed resources lie idle and available. *Per contra* it is the worst possible proceeding, a flagrant abuse and an aggravation of inflation, whenever resources are already fully or over-fully employed: overstoking the boiler.

But there is nothing wrong with the mechanism in itself. It works both ways. It is a most useful counter to inflation. The government's agents can equally go into the open market and

mop up businesses' and people's too-great liquid cash and other short-term liquid assets, by selling to them new medium- or long-term IOUs (bonds). They will only be able to sell such new 'gilt-edged' to them at attractive prices: *i.e.* since it is an inflationary situation they will have to offer the new bonds, locking up people's money for some years to come, at a higher interest rate, a higher yield, than has hitherto ruled in the market. So to counter inflation by this means the government will raise the long-term interest rate. It will be converting what were liquid assets (cash, 'shorts', bank deposits) into investments in bonds for a longish period to come. On balance it will be locking up immediate purchasing-power, mopping it up into the authorities' hands, *but not to be spent again by the government* either on its current or its capital account. Instead the mopped-up purchasing-power will be used to cancel some of the government's short-term or floating debt, its bills in the banking system. When these bills run out at due dates, the government will simply pay them off; fewer will lie in the banks' portfolios; and so the banks' power to expand credit on them as a basis will be cut down, together with the government's own deposits at the banks. Liquidity will diminish. Credit will tighten or be 'squeezed'.

This anti-inflationary or dis-inflationary action is termed 'funding' government indebtedness, because it converts liquid assets into 'funded debt' (long-term bonds). To be really effective, it must turn such liquid assets into il-liquid (long-term) assets on balance: *i.e.* over and above the government's needs to spend on both current and capital accounts, it must mop up some liquid assets and 'fund' them. In other words, over and above the government's receipts from tax-revenues, ordinary savings, and ordinary government borrowings at both short and long term, the government must also mop up some purchasing-power by these 'open market operations' and convert it into long-term investment. It must switch some people or businesses or institutions holding short-term government IOUs (bills) out of them, and into long—or at any rate longer—term bonds. It must reduce floating, but expand funded, government debt. In that way it will curtail the total of credit in the country, by curtailing its own bills (short-term debt) at the banks. As bank deposits form the bulk of all money in a modern industrial society, this curtailing of the banks' ability to create fresh credit on balance will very quickly have its restrain-

ing effect upon purchasing-power, and thus upon inflation.

Of course buyers of the government's new long-term bonds can at once sell them again for cash; but in that case they merely do, in the opposite direction, what we saw the sellers of bonds to the government's agents doing above: they will merely be passing on the headache to others. The cash has got to come from somebody or some institution in the long line of transactions; and in the end it is frozen into long-term bonds, in exchange for a government promise to pay interest on it and to repay the principal some years later.

Naturally there are many refinements of detail in these 'open market operations' into which it is not necessary to enter here. Suffice it to say that both the inflationary and deflationary uses of them—or, to use current cant, the reflationary (expansionist) and disinflationary (contractionist) uses of them—are indicated as required in any industrially developed democracy from time to time, as its economic resources are either under-employed (when more immediate purchasing-power is indicated) or overstrained (when less purchasing-power is required). The control of such monetary operations lies, like that over money itself, in the hands of governments. They alone have the powers to tax, the powers to create or cancel government debt, and the powers therefore to swell or restrain the flow of purchasing-power. If governments manage a country's finances—which are their own finances—aright, they can secure sound money, a reasonably stable price level, and therefore steady economic growth. There is nothing in the financial mechanisms of modern democracies making inflation inevitable or uncontrollable. Its causes lie in politics, not economics. If governments cannot withstand vested interests pressing for more government spending, they cannot reduce taxes, or reduce government borrowing, and counter inflation. Thus behind the economics of inflation lies its politics.