The Problem of Inflation

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DURING the recent election a great deal of ink flowed on the subject of inflation, and if we take the letters published in the *Times* and other quality papers as representing informed opinion in this country, we see that there is a wide divergence of views on the exact nature of the inflationary process. By examining these letters closely, four principal types of "inflation" may be detected: the government's resort to the printing press; the expansion of credit by bank loans, credit cards, hire-purchase agreements, etc.; sundry rises in prices which the economists call cost-push inflation; and inflationary wage deals. The problem which we have to solve is whether all these so-called manifestations of inflation are the result of a single economic process or whether we are confusing inflationary with non-inflationary trends through trying to discover a single remedy for a whole series of economic diseases.

What is at once obvious is that by having such a wide definition of inflation we make it extremely difficult to find any overall cure to remove this disease from the body politic. It is just as if the medical profession had at the turn of the century lumped together cancer, tuberculosis and leprosy as though they were different manifestations of a single complaint and had then proceeded to try and find some magic potion or pill simultaneously to overcome all three. Had they, in fact, not made the necessary distinctions between these diseases, the wiseacres - including the economic pundits - would undoubtedly have long since accused them of taking up a naively non-analytical attitude, and rightly so; yet this seems to be precisely what the financial experts and many enthusiastic amateurs are doing in respect of inflation today. They are, in short, lumping together a wide variety of the causes and effects of inflation and treating them as if they were all causes of one disease; and they are then hoping to cure a whole ragbag of economic illnesses by offering a single remedial prescription. Clearly this is no way to resolve the problem. Before we can possibly hope to cure inflation we have to define in the most precise terms possible what the nature of the process is. This will be the object of the present article, although we shall arrive at a satisfactory definition only after considering a number of other basic economic concepts first.

The most confusing issue in the problem of inflation is the difference between money and credit, which most economists - either implicitly or explicitly - tend to consider as interchangeable concepts. In this country particularly, this identification has led to the stop-go policies of most governments since 1945, because in times of "overheating" credit has been inevitably restricted and money supply allowed to continue uninterruptedly on its expansionary course. We notice the trend towards money-credit indentification even in official documents, for instance in the definition of the money stock. The two most currently used measures are called M1 and M3, the former including notes and coins in circulation together with private sector current accounts; the latter not only the money stock mentioned above in M1, but also all deposits, whether denominated in sterling or other currencies, provided that they are held by U.K. residents in either the public or the private sectors. Even so, do these two measures actually define the total money supply? Not according to a letter by Oliver Smedley to the *Financial Times* (August 23rd, 1974), which states forcefully: 'There is only one money in the U.K. and that is sterling. Additions to sterling are created in only one way, namely by printing new notes.' If this statement is correct, we have to resort to yet another measure of the money stock, that is, to the note issue, or fiduciary issue, as it is technically called. Again, according to Smedley, notes in circulation increased in the year ending August 14, as compared with the corresponding week in the year before, from £4,575 millions to £5,150 millions. This is an increase of £575 millions in one year. Hence to decide which of these definitions is the correct one to use as a basis for measuring and subsequently overcoming inflation, we have to define three principal terms: money itself, credit and the inflationary process.

Let us first deal with money. This represents both a standard quantity of wealth (in a non-inflationary situation) and a means of exchanging fixed quantities of wealth. Since the government normally is the sole issuer of money, a nation's currency amounts in reality to a multilateral contract between the National Bank and all the individuals possessing money within the nation and abroad. Credit, on the other hand, is not money in this sense since it does not involve the National Bank nor the issuing of notes or currency. It is instead a bilateral contract between a creditor and

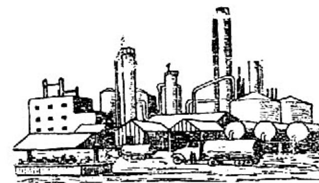
a debtor, an agreement which allows one individual or group to transfer their wealth temporarily to another individual or group for a financial consideration. Since, however, for every creditor there is an equal and opposite debtor, these two entities, by standing in reciprocal relationship to each other, in the overall economic system cancel each other out. The vital difference between increasing the money supply by resorting to the printing press and increasing credit is, therefore, that in the first case more units are brought into circulation, while in the second case they are not. This will have important implications when we come to the determination of a definition of inflation.

Let us at this point consider the first of these possibilities: the increasing of the money supply by governmental printing of extra notes. Since money is a multilateral contract between government on the one hand and the people on the other, it is obvious that by increasing the number of units in circulation the government gains and the people as individuals lose. It is just the same as if in a game of poker one player lost all his chips and then produced another handful from his pocket and proceeded to use them as if they were the original article. The result of such an act, always supposing the poker player could get away with it, is that the original chips would be devalued when measured in terms of real wealth because the quantity of wealth underpinning them would not have changed while the unit standard of its measure would have changed considerably. Likewise, if a government doubles the fiduciary issue or notes in circulation, the price of each article must go up, as long as the stock of wealth does not change commensurately. It is to be noted - and here is the vital point - that this is an across-the-board inflation, since it affects every article for sale in the market-place. Our conclusion must accordingly be that if general prices rise suddenly across-the-board in an economic system it is a sure sign of a currency increase.

What about the expansion of credit, however? Does this too lead to an across-the-board increase in prices? To answer such a question we have to ask ourselves why people seek credit in the first place, and the normal reason is that they wish to buy specific commodities like colour television sets or motorcars. If then a good deal of extra cash appears on to the market at any particular moment, these commodities (depending on prevailing fashions) will inevitably become difficult to obtain and rise in price. But, if no extra currency is simultaneously pumped into the market, the extra money spent on the increased cost of these articles must necessarily be taken away from the costs of other articles, otherwise these other articles could not be sold at all. So what extra credit provokes is not an across-the-board rise in the price of all articles, but a selective rise in the price of some articles and a selective drop in the price of others. A new equilibrium is thereby established until such time as new plant increases the number of television sets on the market and causes their price to sink back; or else the goods that have lost price also become scarce because they are uneconomic to produce, and then their scarcity exerts pressure in turn on the price mechanism. Our conclusion must, therefore, be that increases in credit have different effects from increases in the money supply, the former bringing about selective increases, the latter across-the-board increases, in the price system.

Which of these two processes can be regarded as true inflation? Any answer to this question must be arbitrary; but what is vital is that a distinction should be made between them, and they should not be lumped together as one and the same process. Clearly the cure for monetary inflation is to stop the printing presses, while the cure for "credit inflation" is to channel money into the production of goods which are in short supply by taking it away from those which are abundant. However, since the *Oxford Dictionary* defines inflation as the watering down of the currency, it is perhaps best to use this term only for governmental resort to the printing press, and to describe "credit inflation" by some other name, such as credit expansion. But, in any case, credit expansion is almost wholly innocuous and allows periodic readjustments of the market, while monetary inflation is pernicious in that it devalues savings, prevents the amortization of plant by stimulating large jumps in the price of machinery, and causes a hundred other economic ills. From this we must consequently conclude that the way to stop the economy overheating is not by putting pressure on credit, but by limiting the money supply.

What, on the other hand, about the other two factors supposed to cause inflation, namely the rising of prices like the rise of the oil price on the international market, or excessive wage demands? Do these cause the same kind of inflation as that indicated by



increases in the money supply? Here again we must determine the reasons for these phenomena and I propose to take the problem of internationally rising prices first. The rise, for instance, in the oil price on the international market is well known: it is the re-

sult of the monopoly powers of the Arab states. But a price rise on the international market can equally come about by a natural shortage, by a crop failure for example, or the running out of a vein in a metal-producing country. There are only two solutions to these types of difficulty: the one is the production of more of the required product outside the monopoly and the other the production of substitutes for the product in short supply. Neither of these situations can be solved by increasing the money supply nor by the expansion of credit, so that it follows that we are again confronted with a separate problem which cannot be termed inflation in the same sense as the other two.

Finally, we come to the problem of inflationary wage demands. It is argued, for instance, that the last miners' pay increase was inflationary, partly because it caused the government to print extra currency to meet it and partly because it forced up prices. If it did indeed cause the government to print more money, then by our above definition it was inflationary; but in this case we have to ask ourselves again why the government resorted to the printing press. The answer is that they wanted not only to cushion the effect of the price rise but also to avoid increasing taxation to pay for an increased wage bill in a nationalized industry. Supposing, however, that they had not inflated the currency and had not increased taxation; then they would have had to pass the whole of the cost of the wage increase on to the customer. This would have caused a readjustment to take place in the distribution of wealth within the community, with the miners getting a bigger share of the cake and the rest of us a smaller share in real values, because the cost of the commodity they produce would have risen in price. But if we consider the economy globally, no overall inflation takes place in such a situation, only a redistribution of pre-existing wealth. Indeed, in a free economy substitutes for coal would at once have been introduced to counteract the trend, and in this case the power stations would have been converted to oil or gas, both of which are cheaper than indigenously mined coal. But for political - or spurious trade-balance - reasons the market was not allowed to play its part in substituting for dearer coal, and so the next round of bargaining with the miners is likely to prove even tougher than the last. Needless to say, the same thing applies to any other major industry which through a system of protected markets gains a stranglehold on the community; and the only sure remedy is governmental non-interference with the search for substitutes. But, be that as it may, it is again evident that wage-inflation is not inflation in the true sense, and has the same effects as credit-inflation rather than currency-inflation. Prescriptions for remedying it should accordingly not be lumped together with those for currency disinflation and, what is more, some other suitable term should be found to define it.

What then are the conclusions to be drawn from this analysis? First, that the word "inflation" has been misused to cover processes which are not necessarily inflationary in the true sense of the word. Second, that the various apparently inflationary problems admit of very different remedies and should not be grouped together as manifestations of one and the same problem. Finally, that the term inflation should be kept for monetary inflation, since the other types of process do not disrupt the market permanently in the same way as monetary inflation. Indeed, in addition to the ills enumerated above as deriving directly from monetary inflation, there is also the further and more serious one that it makes the government all-powerful and thereby infringes the liberty of the individual. So, if we wish to retain our freedom and range of choice, the first thing to do is to stop the government using the money supply as a hidden tax to deprive the individual of his savings and industry of its investment capital. What the present government is doing is clear: it is first depriving industry of its means of survival through taxation and then appearing with its nationalization plans in the guise of a saviour.

To our many Friends at Home and Overseas, the Editor and Staff extend their Best Wishes for the Festive Season

" And such a throng I fain would see Stand on free soil among a people free"

— GOETHE