

The curse of inflation

Even a very moderate degree of inflation is dangerous because it ties the hands of those responsible for policy by creating a situation in which, every time a problem arises, a little more inflation seems the only easy way out.

Friedrich Hayek (1960). *The Constitution of Liberty*.

In Ronald Hamowy (ed.), *The Constitution of Liberty*, XVII
(Liberty Fund Library, 2011): 465.

Inflation is a decline in money's purchasing power. Inflation's most visible consequence is steadily rising prices of all or most goods and services in the economy. For a unit of money (say, a dollar) to lose purchasing power is for that unit of money to lose value. And when a unit of money loses value, it takes more units of that money to buy goods and services. In other words, the prices of goods and services bought with that money rise.

By far the most common cause of inflation is an increase in the supply of money. Just as the value of diamonds would fall if a freak meteorological event caused the skies to rain down genuine diamonds, the value of money falls when a nation's monetary authority increases the supply of that nation's money. Just as a rainstorm of diamonds would cause people who are willing to sell things in exchange for diamonds to demand more diamonds from buyers, an increase in the supply of money by the monetary authority causes people who are willing to sell things in exchange for dollars to demand more dollars from buyers.

The cause of inflation, therefore, is quite simple: excessive growth in the supply of money. Stopping inflation is likewise simple: quit injecting newly

created money into the economy. But while stopping inflation is easy in principle (no complex theories must be mastered, and no intricate mathematical problems must be solved), it is often very difficult to stop in practice. The reason is that control of the money supply is in the hands of government officials. Stopping inflation is made difficult by politics, not least because it is politics that usually is to blame for starting inflation in the first place.

Since the demise of the gold standard in the twentieth century, governments have issued “fiat” money. Fiat money is money backed by nothing other than faith in the government that issues it. A government that issues fiat money will redeem units of that money only for other units of that money. The European Central Bank, for example, will redeem 20 euros only for 20 other euros. No gold, no silver, no anything other than itself backs fiat money.

One result of fiat money is to tempt government to finance some, and sometimes much, of its expenditures by creating money out of thin air. Because voters frequently and immediately resist having their taxes raised by enough to support every project that government officials want to fund—and because voters typically don’t see the ill-effects of newly created money until much later—government officials often succumb to the temptation to pay for some of their preferred projects with newly created money.

As we saw in the previous chapter, however, money creation by government can cause serious problems down the road. The process of injecting newly created money into the economy can distort the pattern of relative prices and, hence, encourage an unusually large number of faulty economic decisions—that is, encourage an unusually large number of economic decisions that are revealed only later to be mistaken. Specifically, injecting new money into the economy causes too many resources to be invested in those industries that first receive the new money. Those industries over-expand.

Trouble arises when the truth is revealed that these industries over-expanded. When this revelation occurs, investors and entrepreneurs begin to eliminate what they now see is excess capacity in these over-expanded industries. Efforts to shrink these over-expanded industries, though, inevitably cause hardships. Most notably, unemployment rises as workers are laid off from their jobs in these industries.

During the time that unemployment is unusually high—during the time that it takes for these laid-off workers to find new jobs—political pressure is intense for government to “do something” about this unemployment. One of

the easiest “somethings” that government can do is to keep the inflation going. By continuing to inject new money into the economy, government can for a bit longer prop up prices in the industries that are among the first to get the new money. In short, by continuing to inflate the money supply, government can postpone the discovery by entrepreneurs and investors that the industries that are among the first to get the new money are in fact over-expanded and burdened with excess production capacity.

The benefit to politicians of continuing to inflate the money supply is that, by delaying the discovery of the need to scale back over-expanded industries, they keep the economy *appearing* for a while longer to be healthier than it really is. These politicians, therefore, are at less risk of losing their jobs in the next election.

Economic reality, however, cannot forever be masked by the mere printing of more and more money. As the earlier streams of newly created money work their way through the economy to cause the prices of all goods and services to rise, inflation becomes expected. So for prices in the over-expanded industries to continue to be read by investors and entrepreneurs as signals that the increased investments in these industries are really not excessive, prices in these industries must rise even faster than before. Prices in these industries must rise at a pace greater than the expected rate of inflation.

To cause prices in these industries to rise faster than the economy’s general rate of inflation, the central bank must quicken the pace at which it injects new money into the economy. If the central bank does so, prices in the industries that are first in line to get newly created money will remain higher than they “should” be relative to prices in other industries. Entrepreneurs and investors might then continue for the time being to believe that their increased investments in these “first-in-line” industries are justified. Efforts to scale back these industries are postponed. The unemployment rate, which would have risen today had there been no increase in the rate of monetary expansion, remains low. All looks well—for the present.

Eventually, however, the faster rate of money injection inevitably results in a faster rate of economy-wide inflation. Prices throughout the economy are now rising at a pace to catch up with the rising prices in those industries that are among the first to receive the newly created money. As a consequence, prices in these “first-in-line” industries stop sending out misinformation. These prices begin to reveal the fact that investments in these

industries are indeed excessive—that productive capacity in these industries is too large. And so the only way the monetary authority can prevent investors from scaling back these industries and from laying off workers is to ramp up even more the rate of monetary expansion.

The monetary authority soon finds itself in a difficult spot. If it stops inflating the money supply (indeed, even if it simply fails to accelerate the rate of growth in the money supply), the industries that over-expanded because of earlier injections of new money will contract. The resulting rise in unemployment creates political pressures for government to “do something” to raise employment—something *other* than counseling the public to patiently wait while industries are restructured to be more economically sustainable. Accelerating the rate of inflation is one maneuver the government can take to keep employment high *for the present*.

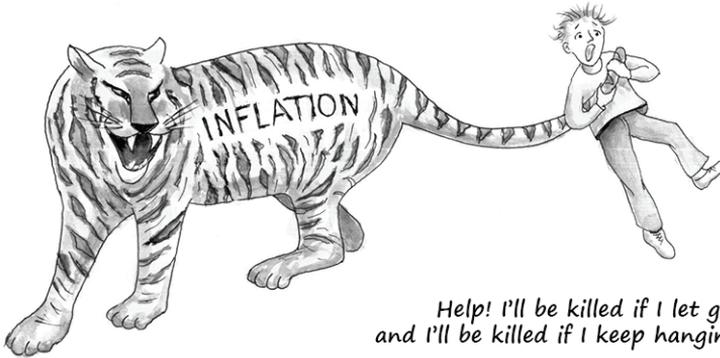
But the increasing rate of monetary expansion leads to an increasing rate of inflation, which causes a host of other economic ills. These other ills include rising interest rates. (Bankers and other lenders will charge higher interest rates because they expect to be repaid next year in money of lower purchasing power than is the money they lend out today.) The other ills also include greater anxiety among workers that their wages will not keep pace with inflation—so workers demand higher wages today, ahead of the expected higher inflation. (The danger here is that if the rate of inflation turns out to be less than expected, workers’ wages will have risen too high, causing some workers to lose their jobs or some employers to suffer unexpected losses.)

More generally, because monetary expansion does not cause all prices to rise in lock-step with each other, the higher the rate of inflation, the more distorted becomes the pattern of relative prices throughout the economy. The more out of whack individual prices become relative to each other, the less reliably do these prices guide entrepreneurs, investors, and consumers to make correct economic decisions. Higher rates of inflation, therefore, result in greater misuse (greater “misallocation”) of resources. The economy’s performance becomes worse and worse.

To cure this problem the monetary authority need only to stop injecting new money into the economy. But the cure isn’t instantaneous. Not only does it take some time for people to stop expecting future inflation, but, also, it takes time for workers and resources to shift away from industries that over-expanded because of inflation and toward industries where these workers

and resources will be more sustainably employed. By continuing inflation today, the monetary authority might be able to delay just a bit longer the need for over-expanded industries to shrink, but doing so also causes inflation throughout the economy to worsen.

Politically, the monetary authority might be thought of as having grabbed (as Hayek described it) a “tiger by the tail.” While everyone agrees that a tiger ought never be grabbed by its tail in the first place, once someone *does* grab a tiger’s tail, that person is at risk of being bitten and clawed when he lets go. But by holding on to the tiger’s tail, he can delay facing the risk of being bitten and clawed. Holding on, though, only makes the tiger angrier, so that when it finally does break free—as it eventually will—the beast is even more likely to attack, and to attack with greater fury, the person who held its tail.



Understandably, at each moment in time, the person holding a tiger by the tail is tempted to hold on just a bit longer to delay the risk of being mauled by a big angry cat. Every moment of delay in letting go, however, only worsens the danger that will likely befall the person when he eventually does let go. And to make matters worse, at some point the tiger will become so furious that it will manage to break free on its own. The danger to the person who held on to the tiger’s tail for that long will be enormous.

The difficulty of stopping inflation is very much like the difficulty of letting go of a tiger’s tail. The mechanics of doing either task are incredibly easy: just stop printing money (to stop inflation) or relax the muscles in your hand (if you’re holding a tiger by the tail). Yet in light of the anticipated consequences of stopping inflation or of releasing a tiger’s tail, the task in either case is indeed challenging. In both cases performing the task requires not

only the wisdom to see that continuing the current course will only make matters worse, but requires also the courage to confront the danger as soon as possible instead of delaying that confrontation.

Unfortunately—and here the analogy with holding a tiger by the tail breaks down—by continuing the growth of the money supply, many people in political power today can themselves *personally* escape any resulting political dangers. The bad effects of more inflation today won't materialize until sometime in the future, when many of today's officials will be out of office. So officials in office today can, by keeping the money supply growing, make the economy appear to be healthier than it really is, while the costs of creating this illusion will be borne only in the future by mostly different officials.

This political bias in favour of inflation is the chief reason justifying arrangements that strictly regulate changes in the supply of money. Returning to the gold standard is one option. Alternatively, the economist Milton Friedman (1912-2006) famously proposed a “monetary rule” that would prohibit central banks from expanding the money supply beyond some very small amount (say, by no more than three percent annually). Hayek himself came to favour denationalization of money—that is, getting government completely out of the business of issuing money and controlling the money supply. Competitive market forces would instead be responsible for supplying sound money. (Friedman himself, just before he died, became so skeptical of central banks that he argued that government be stripped of *any* power and responsibility to regulate the supply of money.)

Whatever the particular method used to eliminate political discretion over the money supply, eliminating such discretion should be among the highest priorities for those who seek an economy geared to solid, sustainable, and widespread economic growth.

Just as recovering alcoholics are wisely advised to avoid alcohol completely—and just as thrill seekers are wisely advised never to grab the tails of tigers—a people are wisely advised never to allow their government to exercise discretion over the supply of money. Following such a rule is the only sure way to avoid inflation and the many ills that it inflicts on an economy.