ORIGINAL

LIBERTARIAN PARTY ON THE ISSUES

Inflation

There is a gloomy unity among Americans today that our country's number one economic problem is persistent and accelerating inflation. There is good reason for such a bleak consensus. The consumer price index increased 13.3 percent during 1979, and it was up 17 percent in the first quarter of 1980. While the rate moderated during early summer, producer prices were still rising, so we can expect continued consumer price rises to follow. The dollar has lost 27% of its value in just three and a half years.

But like many other ills that face us, the cause of this rampaging inflation seems mysterious. Why do all prices continue to soar? And, more to the point, who is responsible for inflation and what can we do to stop it?

There is a solution to the problem of inflation. It can be ended but the answer does not lie in the usual welter of feeble excuses that assaults the average consumer.

The government treats inflation like some widespread disease. Somehow, for some obscure reason, inflation catches on and spreads; and the responsibility of the federal government is to marshall all the weapons at its command to "combat" this dread epidemic. Like a great doctor, operating in our behalf, the government is supposed to find the source of the infection and end it. And if the government seems to lose all the time, as it does, well, disease hasn't been stamped out either.

The financial pundits of the media seem to have formed a causal theory of inflation. Month after month, they say, some price is bound to rise more than others, and so this one price bears the public onus for inflation for that month. Some months, food or housing prices get the blame for inflation; other months, OPEC, oil, or gasoline costs are pinpointed as the guilty parties. There are, however, several problems with this approach. If one month food, the next month oil, etc. goes up, then why is it that regardless of the month, all prices are always increasing? Why don't they ever go back down?

For if the problem is specific, individual prices, they should go down from time to time. Take the price of coffee, for example. Every few years, a large part of the coffee crop in Brazil freezes over. The big drop in coffee production raises the price of coffee. The supply of coffee drops, but the consumer demand for it is the same. What happens? The price goes up because the smaller amount of coffee has become more valuable. The supply becomes equal to or greater than the demand. But

in a year or so, the frost is gone, the coffee crop goes back in gear, and the price of coffee falls back to normal. So how come individual prices across the board, keep rising, year after year?

The problem, in fact, has nothing to do with individual prices. For let us stick to the coffee example for a moment. If the price of coffee rises, then consumers have less money to spend on other products; their incomes are the same and they will have to reshuffle their expenditures. If they have a certain number of dollars but still want coffee at its new increased price they will have less money to spend on other goods than they used to, the demand for other goods will slacken, there will be more of them, and as their supply outstrips the demand their prices should go down. If they spend less on other products, then,the prices of those products should fall. So a decline in the coffee crop should cause some prices to rise, others to fall, but yield no overall rise in prices.

So the inflation problem is unrelated to such particular industries as food, housing, or energy. If OPEC raises oil prices, than the rise in oil or oil-related prices should be offset by declines in other areas. Why don't these declines take place?

WHO'S TO BLAME?

Everyone has a favorite culprit to blame for inflation. Usually, people accuse some group of suppliers of specific goods or services. Since business people charge prices for their products, they are the first to be blamed. Why is grocer X so infernally greedy that he keeps jacking up the prices for his wares? Or manufacturer Y for raising the prices of his goods?

The problem with blaming business greed for inflation is that it really assumes that greed has greatly multiplied in the last few years. After all, business people were presumably just as greedy in the 1950s as they are today. So why is it that prices hardly went up at all a generation ago and are skyrocketing now? Has greed really increased by tenfold in the last couple of decades? And if businesspeople are so powerful that their greed can determine prices, do they stop at a 10% or 20% annual inflation rate? Why not 100%? 500%? What is stopping them?

The same flaws negate the other common explanation for inflation: union greed. Unions, it is charged, cause inflation by demanding higher and higher wages. But unions were even more powerful in the 1950s than they are today. Why didn't their demands cause any havoc then? In both the case of the unions and the businessmen, the focus is awry. The problem is not with greed: every person and every group would like to see their selling price or their wage increase astronomically. The real question is: why don't they? What forces are keeping prices and wages from going through the roof all the time if desire and greed on the part of the sellers are sufficient to determine price or wage rates?

The answer is that prices and wages don't go still higher because consumers simply don't have the money to pay for the increases. If the steelworkers union insisted that all their members get paid no less than $100,000 a year, they would all quickly be unemployed. The same would be true if the makers of Wonder Bread decided to insist on a price of $10 a loaf. The could ask for any price they wanted, but they would not get it if people cannot pay it.

If we look at the supply side, in fact, the production of goods and services overall, despite crippling taxes and controls, the supply of goods and services is still increasing by a few percentage points every year. So if the supply of goods is continually increasing, their prices should tend to fall, not increase. The more goods there are, the less they should cost. Why aren't prices going down? The answer is that consumers are more able to pay more money for products because the supply of money in their hands keeps rising. Businesspeople can charge

higher prices and unions higher wages because more money keeps pouring into the economy, raising consumer incomes and in turn raising the amounts that consumers are willing to spend. The increase in the money supply is much greater than the natural tendency of the market economy to increase production and lower prices.

So the culprit we have to look for as responsible for inflation is not sellers of goods and services or manufacturers of particular products. The guilty party is the manufacturer of money, the firm that keeps increasing, day in and day out, the supply of money in the economy. The manufacturer of money prints all the dollars, and then pyramids on them six times as much new checkbook money through the banking system which it totally controls. Who is this manufacturer? It is the federal government, the only institution in the country that can legally print and create new money.

So we now see the hypocritical moral position of the federal government in this whole affair. Pretending always to be the knight in shining armor trying to combat inflation, the federal government itself has been solely responsible all along. The government, through its Federal Reserve System, is the sole legal "counterfeiter" in the society, for it alone is empowered to create dollars.

How do more dollars get into our economy? Since the dollar is no longer backed by gold or anything else of real value, the federal government and the cartellized banking system face few restrictions on their ability to create money. When the government runs a deficit budget -- spending more than it takes in -- it has to make up the difference. It does this by borrowing money -- by selling bonds and other securities to banks or other buyers. Where do the banks get the money to buy more and more government securities? This is where the mysterious-sounding phrase "monetization of the debt" comes in.

The Federal Reserve Boards goes into the open market and buys outstanding government securities from banks and other bondholders. Where does the Federal Reserve get the money? It creates the money out of thin air by writing a check on itself. No one had the money before the Federal Reserve spent it; it was created with the stroke of a pen. The bank from which the Federal Reserve bought the security, of course, now has the new money. It deposits the money in its account at the Federal Reserve, increasing its reserves, and then has more money to lend out or buy government securities.

The Federal Reserve, which centrally controls the entire banking system, permits the banks in the system to pyramid loans on top of reserves by an eventual multiple of about 6 to 1. That is, if the Federal Reserve buys $10 million worth of securities from a bank, increasing its reserves by that amount, the bank can then buy $60 million of new government bonds or other securities. That's called "fractional reserve banking." After each of these transactions there is, say $100 million more in the nation's money supply than there was an hour ago, but the supply of goods has not increased. So every American's dollars have just decreased in value. This rapid pyramiding of new money created out of thin air -- by the Federal Reserve and the banks -- is what causes inflation.

Who benefits from this process? The government, of course. Just as you or I would benefit if we could legally print money, so the government benefits from creating money for itself. The difference is that if you or I did it, it would be called counterfeiting; when the government does it, it's called "monetary policy."

But there are other people who benefit as well, and that explains why the political process always produces inflation. The people who benefit are those who get the new money first, before it circulates through the economy and raises all prices. Defense contractors, other companies who do business with the government, government employees, consultants, and the other special interests who cluster around the public trough all benefit from inflation and don't

really want to see it stopped. When the government creates new money, it goes to these people first. They spend the money while prices are still at their previous levels; then, as prices begin to rise in response to this new money, the rest of us find our dollars will buy less. The result is that there is a massive transfer of buying power from the American people to those special interests with access to government money. Middle class and poor Americans end up subsidizing Chrysler, Lockheed, and high-paid government bureaucrats and consultants.

Another particularly insidious and all-too-familiar effect of inflation is the "promotion" of American taxpayers into higher and higher tax brackets, so that a higher percentage of their income is taken by the government. For example, assume that a taxpayer makes a gross income of $20,000 this year and has $5,000 worth of deductions. The federal income tax he pays on the remaining $15,000 is $2,352. Now assume that he is lucky enough to make enough money next year to match the 18 percent rate of inflation in the first quarter of 1980. His income would now be $23,600. Assume his deductions also increase by 18 percent, to $5,900. His taxable income is now $17,700 -- which buys no more than this year's $15,000 -- but the tax he pays increases to $3,123, an increase of 33 percent.

Even if you adjust the tax for inflation, the government has ripped him off for $348 -- and he's one of the lucky ones, whose gross income has actually kept pace with inflation. Generally, for every 1 percent increase in inflation, taxes rise by 1.6 percent -- giving the government another incentive to keep inflation.

Another problem caused by inflation is the "boom and bust" cycle of inflation and unemployment. Government manipulation of the supply of money and credit leads to a distortion of interest rates for businesses. Inflationary credit creation by the Federal Reserve System makes new funds available for business expansion without a corresponding voluntary act of saving by investors and consumers. The ratio of consumption to savings is distorted from its "equilibrium" or free market level.

To businesspeople, the new funds seem to be genuine investments. But unlike free market investments, their funds do not arise from voluntary savings. The new money is invested by businesspeople in various projects and paid out to workers and suppliers as higher wages and prices. But much of the money is invested in the production of goods for which the real market is much less than the government interventions made it appear.

As the new money filters down to the whole economy, consumers receiving it as wages do not spend it in the way businesses expected. Many investments are then revealed to be wasteful and not based on real consumer preferences. When this happens, businesses fail, plants close, and workers lose their employment -- forced from jobs by the machinations of there Federal Reserve. In this way inflation always leads to unemployment; and when we stop inflation, we'll greatly reduce our unemployment problem as well.

Professor F.A. Hayek, the Nobel Prize-winning economist, wrote about this in his recent article Unemployment: Inevitable Consequence of Inflation. In his words,

> Inflation, has, of course, many other bad effects, much more grave and painful than is realized by most people who have not lived through a serious inflation. But the effect that is most devastating, and at the same time the least understood, is that in the long run inflation invariably produces extensive unemployment . . . We do not have the choice between inflation and unemployment, just as we cannot choose between overeating and indigestion: Overeating may be very pleasant while we are doing it, but the day of reckoning -- the indigestion -- is sure to follow.

To reduce unemployment, we must stop inflation. Any other "solution" to unemployment is just a quick fix that won't address the real problem.

During the 1970's the money supply increased at a rapid rate. The rate of increase for M2 (one of economists' several calculations of the money supply) rose from 7 percent in 1973 to 14.1 percent in 1976. It has been somewhat lower since then -- 8.8. percent during 1979 and even lower in 1980 -- but it is still increasing steadily. Because of the different calculations of the total money supply -- M1-A, M1-B, M2, M3, and so on -- along with changing expectations and time lag, we cannot expect money supply expansion and inflation to increase at exactly the same rate. Nevertheless, we would expect that a faster expansion of the money supply would lead to more inflation. And indeed, a chart comparing the rate of increase of M2 with the increase in the Consumer Price Index over the last nine years shows a remarkable correlation. Both the money supply and the price level roughly doubled in that period of time. (See chart on page 6.)

In the last year or so, inflation has been increasing even faster than the money supply. Why is this? Because people are beginning to feel that inflation has become a permanent condition. They anticipate further inflation, spend money today instead of next year when prices will be higher, and hence aggravate inflation still more.

Many economists make the mistake of trying to solve this problem by getting "better" people to run the Federal Reserve, to try to induce the Federal Reserve not to inflate so much and to cut down its purchases of U.S. securities. This may work for a brief while, but it leaves the essence of the problem untouched. Inflation can only be stopped by abolishing the power to inflate. To do this, we must abolish the government's power to counterfeit. In fact, we must separate the federal government completely from the money and banking system. Only separation of money and the state can do the job.

True separation of money from the state would mean abolition of the Federal Reserve's power to counterfeit, and indeed of the Federal Reserve System itself. We must return to a system in which the free market decides the currency unit, and where the supply of money is in the hands of the people rather than the politicians. Money itself, in that case, must be a commodity produced on the market, like gold, rather than pieces of paper issued by the state. Banking should once again be free of government control and dictation.

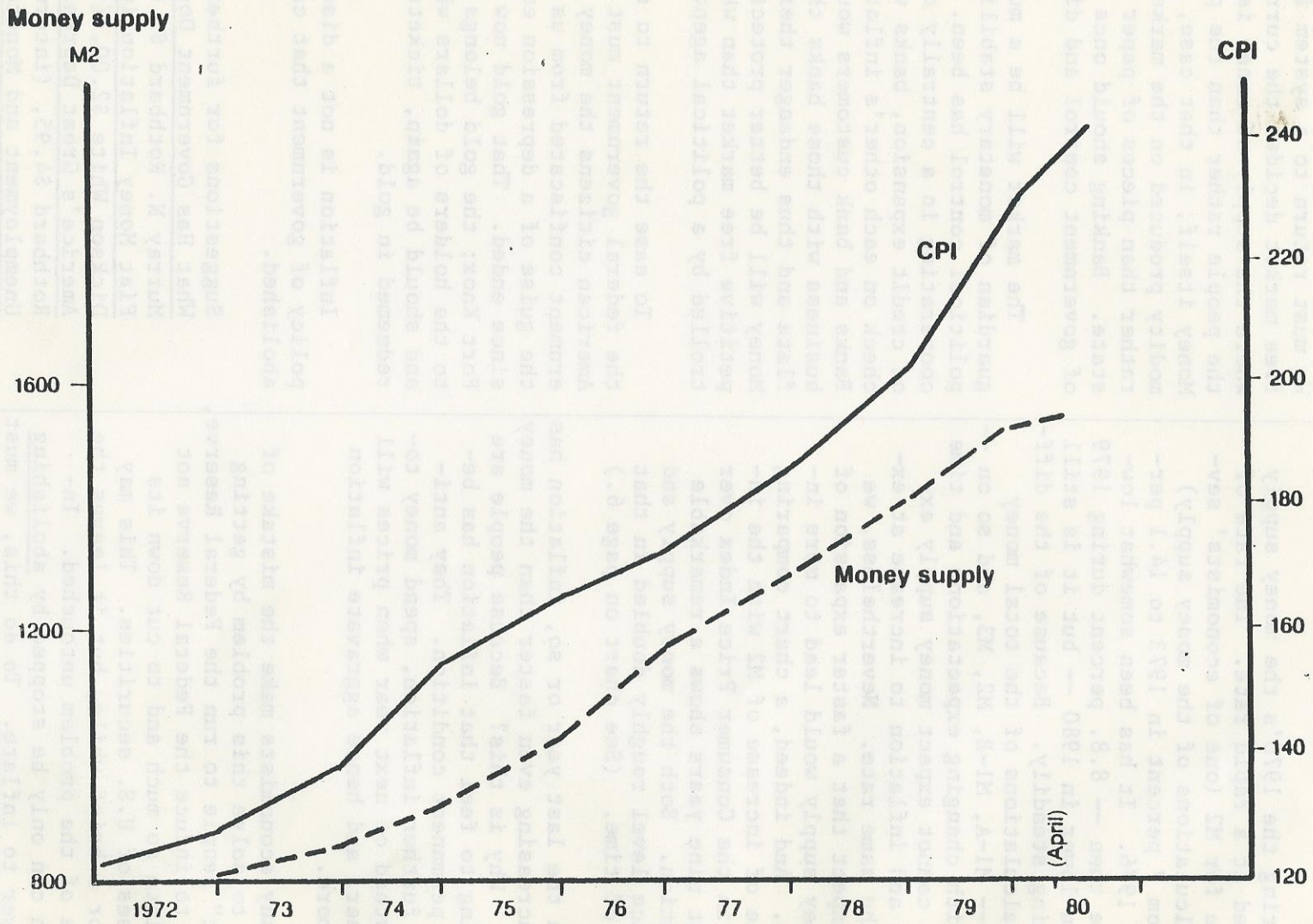
The market will be a much safer guardian of monetary stability than political control has been. Instead of cooperating in a centrally controlled system of credit expansion, banks would act as a check on each other's inflationary impulses. Banks and bank customers would choose to do business with those banks that did not inflate and thus endanger their deposits. Money will be better protected in a competitive free market than when it is controlled by a political agency.

To ease the return to sound money, the federal government must return to the American citizens the money that the government confiscated from us in 1933, under the guise of a depression emergency long since ended. That gold now lies buried at Fort Knox; the gold belongs to the people, to the holders of dollars which once were, and should be again, tickets that can be redeemed in gold.

Inflation is not a disease; it is a policy of government that can and must be abolished.

Suggestions for further reading:
What Has Government Done to Our Money?, Murray N. Rothbard $2.00, (introductory)
Fiat Money Inflation in France, Andrew Dickson White $2.00, (introductory)
America's Great Depression, Murray N. Rothbard $4.95, (intermediate)
Unemployment and Monetary Policy, F.A. Hayek $2.00, (intermediate)
The Theory of Money and Credit, Ludwig von Mises $6.00, (advanced)

These books and more are available from the Libertarian Party Book Service, 206 Mercer Street, N.Y., N.Y., 10012. Add $1.00 for postage and handling.


Money supply
M2
CPI
CPI
Money supply
1600
1200
800
240
220
200
180
160
140
120
(April)
1972
73
74
75
76
77
78
79
80