Inflation and its Cures

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By

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Introduction

Inflation is the most pressing and grossly misunderstood problem of our time. The cures of inflation are simple. The only difficulty with inflation is that its cures are politically incorrect, and thus are never implemented. Political correctness or incorrectness does not render the study of inflation useless. Ideas are always important in the long run, and so we need to understand the problem of inflation and its cures without worrying for its political nature. For us its economic nature is of utmost importance than anything else.

Inflation and Its Causes

A clear definition of inflation is essential to fully comprehend its various facets. This is important because the modern mainstream economics definition of inflation is faulty, and thus completely misguiding. Mainstream neoclassical economics defines inflation as, *an increase in the overall level of prices in the economy (Mankiw, 2001, p. 13).* A logical scrutiny of this definition reveals its serious errors. Traditionally, after the Keynesian revolution [sic] in economic thought, inflation is regarded as a macroeconomic phenomenon, and so the term *overall level of prices* in its definition. But the crucial question here is, does such phenomenon of *overall level of prices* exist in the market of individual exchanges? And the answer of this question is a definite No. In the market economy there are only individual product prices prevailing at a given moment of time. Adding up all these different prices in one index, and then averaging them out to calculate various indexes like WPI or CPI is wrong because there is no average price here, and there are no average consumers who are paying this average price. Measurement of purchasing power of money is an impossible task because, as believed by the economists, money never remains neutral. Its value is always changing in the market. Every price of goods and services is determined by a unique

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relationship between demand for goods and services and money on one side, and their stock on the other. In every exchange these factors are so intricately interwoven that it is impossible to treat them separately. Goods and services are only expressed and appraised in terms of money, and not measured [2]. Money is not an objective standard of measurement. Moreover, prices do not have any economy wide ‘level’. Different product prices rise and fall several times in the market. Prices also do not rise at once so that we can say that the *level* of overall prices has risen. Actually when inflation is underway[3], different product prices changes step by step as newly printed money spreads throughout the economy. This phenomenon was first analyzed by Richard Cantillon in his famous *Essays* (Cantillon, 2001), and is known as *Cantillon Effect* after him.

Apart from the impossibility of comparing various money prices, and the untenability of the concept of *level of prices*, the mainstream neoclassical definition also focuses solely on the *effects* of inflation rather than its true causes. Rise in prices is not a cause of inflation, but is its effect. Focusing the attention on effects of inflation prevents one from knowing the true causes of inflation. And unless and until the true causes of inflation are known it is impossible to cure it.

Let us then see the true causes of inflation. To understand the true causes we must define inflation in such a way so that its definition focuses on its causes and not on its effects. This correct definition was given by the Austrian school of economics. Henry Hazlitt defined inflation as, ‘*an increase in the quantity of money and credit. Its chief consequence is soaring prices. Therefore inflation—if we misuse the term to mean the rising prices themselves—is caused solely by printing more money. For this the government’s monetary policies are entirely responsible’ (Hazlitt, 2004, p. 41).*

Let us now analyze what happens when the quantity of money and credit increases in the economy.

Inflation and Its Consequences

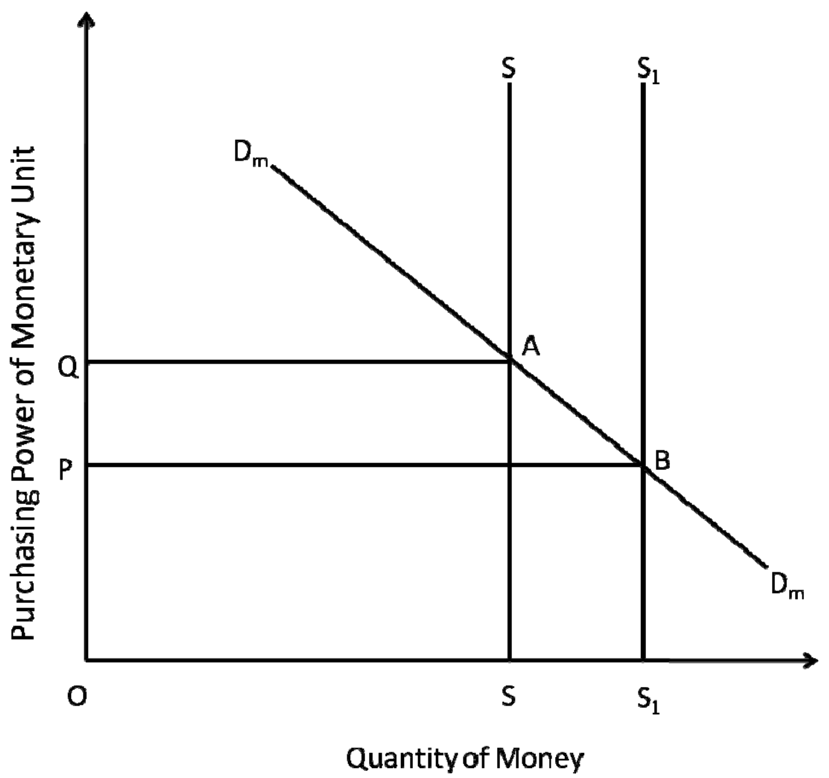
Rising prices

There are two chief ways in which the quantity of money can increase in the present day monetary regime of government paper money with its central bank, and the system of fractional reserve banking. We take each case in succession and see its consequences.

[2] For a detailed critique of this mainstream view of ‘money as an objective standard of measurement’ and ‘level of price’ please refer to, (Rothbard, 2004, pp. 831-851)
[3] We will soon see the correct definition of inflation.

Money is one commodity in the individual market exchange. This knowledge of *money as a commodity* was widespread in the past, but is lost today. Carl Menger (Menger, 2009) demonstrated how some commodities (e.g. gold and silver) have historically evolved as money (a common medium of exchange) from the barter economy. And because money is just another good/commodity into the market process, its price is determined, similarly like the prices of any other good, by the forces of market demand for money and its available stock. Price of money is its purchasing power. Purchasing power of money determines how many goods and services a unit of money can buy in the market. This also determines person's real income. We now see how price of money is determined. Figure 1 presents the money relation. On vertical axis is the PPM (purchasing power of money), and on horizontal axis is the quantity of money. D_m curve represents the total demand for money to hold, and vertical curve SS presents the total available stock of money in the society. The intersection of demand for money and the total available stock of money at A determine the initial purchasing power of money at OQ. Now, it can be seen that, as the total quantity of stock increases from OS to OS_1, the purchasing power of money (its price in terms of other goods and services) decreases to OP from the initial higher level of OQ.

Figure 1 Money Relation (Determination of Purchasing Power of Money)



This simply means that now a unit of money can buy less number of goods and services. It also means that the real income of a person, who is having these units of money in his cash balances, has now declined due to this increase in the quantity of money. Looking from the goods and services side, this means that prices of goods and services have risen! Less goods and services are now selling at the same amount of money than before the increase in the quantity of money. This price rise of goods and services is the effect of inflation for which we all worry a lot.

As our analysis shows, money is just another commodity whose price is determined by its demand and supply in the market. The only important difference between money commodity and other commodities is, that when price of other commodities (e.g., Milk) decline it confers social benefit, but when price of money declines it results into social misery! Money is a common medium of exchange. Everyone demands money to later exchange it for other goods and services. No one wants to consume money directly. Precisely because of this reason, increase in the quantity of money or stated otherwise, erosion in the purchasing power of money results in social misery by lowering the real income, and thus standard of living of the people.

Sometimes prices of goods and services do not rise rapidly or are stable when inflation is underway. This happens because most probably the productivity of labor and capital goods is rising with the rise in the quantity of money. But, here again, inflation is eroding the standard of living of people by not allowing the market prices of goods and services to fall due to the increased productivity of labor and capital goods. Increased productivity of factors of production will increase the supply of various goods and services, which will lower their prices. We do not see these lower prices because of inflation[4]. What we see is slowly rising prices or stable prices. But the notion of "stabilization of price" is absurd[5]. Everyone benefit when prices fall, and not when they remain stable or when they are rising. The tendency of prices is to fall in the free market, but government intervention in the free market through inflation never allows this fall to materialize.

Booms and Recessions

Rising prices is one menacing effect of Inflation, but not the only one. Misallocation of resources is another chief evil effect of Inflation. The easy money policies of the

[4] This is the unseen effect of inflation.
[5] And thus absurd are all the central bank and governmental policies of *price stabilization*. We do not want stable prices. We want falling prices.

government's central bank induce entrepreneurs for starting new capital projects. These projects are unsustainable in the long run because they are not backed by actual savings of people. Mal-investment results in the capital goods industries due to artificial lowering of interest rates by the central bank. Resources move from the consumer goods industries, where they are actually required, to the capital goods industries. This artificial boom finally ends in a bust[6]. Moreover, if governments continue to inflate during recession time too, then recessions turn into great depressions[7]. 1929's Great American Depression and Japan's 20 years long depression of present time are prime examples of this phenomenon[8]. Such recessions and depressions bring economic hardship and misery for the masses.

After seeing the dire effects of inflation we now turn our attention to the chief sources of increase in the quantity of money. Thorough understanding of these sources can only enable us in eliminating inflation.

Sources of Inflation

Government Money Printing Through Central Banks

We live in a world where governments around the world have monopolized the issuance of money supply in the economy. The legal tender laws inhibit any private printing of money. There are two major reasons why governments have slowly monopolized the money market. Both these reasons are related with the increase in governmental activities in our times. We now turn our attention towards these reasons.

Welfare State

States use to be very limited in old times. Its only activities were of protecting life, liberty and property of its citizenry. This is the so called *police* or *the night watchman state* of the olden times. But once monopoly of protection was granted to the State, it slowly expanded its powers and its interventionary activities (the problem of, who will watch the watchman?!). The police state became *the welfare state* of modern times. Today we see that government is involved in almost every activity one can think of (except providing protection and justice to its people[9]!). This expansion in activities is only possible when it has resources (e.g. money)

[6] For a groundbreaking explanation of this phenomenon please see, (Hayek, 1967; Mises, 2009).
[7] For a detailed explanation of this phenomenon please refer to, (Rothbard, 2000).
[8] Discussion of Japan's long economic debacle is given in, (Powell, 2002). And the recent Dubai debacle is another case at our witness here.
[9] Professor R J. Rummel of the University of Hawaii has estimated that, governments around the globe have killed 26,20,00,000 of its own people (See his website for evidence and more analysis of this data -

to carry them out. And these resources it can only have if it has a direct control over the money supply. This control it gained by slowly monopolizing the money market. This monopolization was necessary because government cannot produce anything to earn money. Government cannot acquire money justly through the sell of its production like other individuals. There are three chief ways through which state can acquire resources:

1. Taxation,
2. Public debt; and
3. Money printing.

First two options are limited in its scope for acquiring increasing amount of resources. Government cannot impose higher tax rates on its citizens because that will result in public uproar against the government, and a possible demise of its rule. Also, as the famous *Laffer curve* demonstrates, increased tax rates will result in decreased revenues from taxation. Through public debt also it cannot acquire more resources because those funds are available in limited amount, depending on how many people are voluntarily willing to buy government bonds. In such a situation, only third option is open for acquiring the endless amount of resources. Printing money is the easiest and the most hidden way for the government to get hands onto the needed resources. For this reason, and this reason only, it has monopolized the money market. This way, whenever in need of money, it can just give orders to central banks to run the printing presses day and night[10]. One clear evidence of this is the endless money which government is printing in this recession time to unduly bailout various banks and businesses (the so called *stimulus packages)*. Various governmental plans require money, and this money is acquired easily by printing it. This is the one major way in which the quantity of money is slowly expanding in today's societies. This slowly increasing quantity of money (i.e. inflation) is pushing prices upward in the economy. Whenever government prints and spends money quickly prices soar up quickly, as is happening right now. Prices of various goods and services were much lower 25 or 50 years back. We have frequently heard our grandparents complaining that in their time things were much cheaper than today. We all hear this from our grandparents, but very few of us try to find out the true reason behind this

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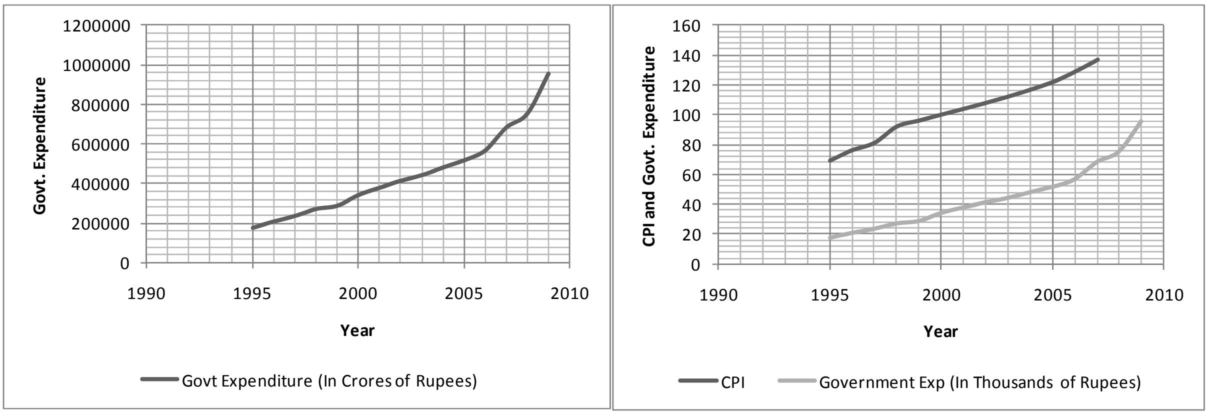
http://www.hawaii.edu/powerkills/). This phenomenon is described as *Democide* by Prof. Rummel. And once we take into account people being killed between various nations wars (see next section for discussion of this issue) the number reaches to mind boggling heights.

[10] The official words for this process are *monetizing debt, market borrowing* etc. These fancy words are linguistic tricks of government. Governments do not borrow anything from the market i.e., people. Their borrowings come directly or indirectly from the Central banks. The complicated mechanism of issuance of treasury bills (T-bills) etc., is a hidden way of fooling everyone. To get a clear picture of central bank as giant counterfeiting machine please read Robert Murphy's illuminating article (Murphy, 2010).

situation. Our analysis tells us that this price rise is due to slowly increasing governmental expenditures. As government expanded its activities by printing money, it resulted into slowly (and sometimes rapidly) rising prices. We must not forget one fact, which is historically proven, that *all governments are inherently inflationary in nature*.

Figure 2 below presents the data of Indian government's total expenditure in various years as seen in its budget, and the CPI (consumer price index) with all its defects[11]. Evidence of the *welfare state inflation* (figure A), and its effect (figure B) can be clearly seen.

Figure 2. Indian Central Government Total Expenditure with CPI[12,13]



(A) (B)

Misallocation of Resources through Government Spending and Rising Prices

Increasing government expenditures result into rising prices from another way too. This way is misallocation of resources by the government. Government squanders the scarce resources; this results into lower supply of those goods and services which consumers are demanding. Free market allocates resources exactly where they are needed by the consumers. For example, suppose in the economy there are three types of fruits available, banana, oranges and apples. Consumers are enjoying all three fruits in the present time. Now suppose consumer taste changes, and instead of eating oranges they now want more bananas. They

[11] CPI is used here for the comparison because that is the only available indicator of rising prices. What we actually need is a time series data of separate product prices. For example, the price of groundnut oil in two different years, say, 300 Rs/Ltr in 1980 and 1500 Rs/Ltr in 2009, provides a clear understanding of rising prices to the common man, instead of any index number or a percentage figure.

[12] Source: Union Budget (various years) and KILM 6 software, ILO.

[13] In figure 2 (B) expenditure data is converted into thousands of rupees to facilitate its comparison with the CPI.

will increase the demand for banana, and this will increase the price of banana which will increase profits of banana farmers. On other side the lower demand for oranges will reduce the price of oranges, and thus profit of orange farmers. Seeing the higher profit of banana farmers some orange farmers will shift their production to banana from oranges. Resources will flow in the direction of banana production instead of orange. This entry of new firms will increase supply of banana which will lower the price of banana. This situation will continue until new changes occur in the underlying market data e.g. consumer taste, their income, natural factors etc. In our dynamic world market thus allocates resources where they are required most by the consumers. Producers are guided by consumers. But governments do not allocate resources according to the consumers' requirements. They allocate resources according to the wishes and whims of their central planners, politicians, special interest groups etc. Only handful of such government people decide where to direct resources. For example, suppose, consumers' needs are food and clothing but their government will spend resources in producing gardens and guns! This will reduce supply of food and cloth because private sector resources for production of these items are reduced through government taxation, debt and inflation. And this reduced supply of various goods and services will push up their prices in the economy.

Warfare State

If *welfare state* is one evil cause of inflation then *warfare state* is another sinister cause of inflation. For the state, any activity outside its own boundaries requires that it somehow gain control over the resources of other nation states. This is only possible if they attack them and win their territories[14]. This desire of winning other nation states has resulted into the longest and bloodiest wars in the history. All these battles require gargantuan amount of resources[15]. Here again, taxation and public debt will be insufficient for acquiring these resources. Printing money is the only way which enables governments around the world to fight these bloody battles. Without the central banks and their printing machines it is impossible for any nation state to wage such costly wars against other nation states[16].

Figure 3 below presents the evidence of increased war spending in various regions around the world.

[14] The peaceful way of *free trade* with other nations again is politically incorrect, and so hardly tried by the governments.
[15] For example, Joseph Stiglitz in his famous work, *The Three Trillion Dollar War: The True Cost of the Iraq Conflict (Stiglitz, 2008)* estimates that American cost of Iraq war alone is three trillion dollars.

[16] For the evidence of the sinister role played by the central banks in funding state wars see, (Koning, 2009).

Figure 3. World Military Expenditure.

Military expenditure, by region, 2008

Region	Spending, 2008 ($ b.)	Increase, 1999–2008 (%)
Africa	20.4	+40
North Africa	7.8	+94
Sub-Saharan	12.6	+19
Americas	603	+64
Caribbean	..	
Central America	4.5	+21
North America	564	+66
South America	34.1	+50
Asia and Oceania	206	+52
Central Asia	..	..
East Asia	157	+56
Oceania	16.6	+36
South Asia	30.9	+41
Europe	320	+14
Eastern	43.6	+174
West and Central	277	+5
Middle East	75.6	+56
World total	**1226**	**+45**

To allow comparison over time, the above spending figures are in US dollars at constant (2005) prices.

Source: SIPRI (Stockholm International Peace Research Institute) Yearbook 2009.

Indian defense budget is increasing every year.

Table 1 below shows this data. It is evident that the military expenditures are rising with time.

Table 1. Indian Defense Expenditure

Year	Total Defense Expenditure (Rs. in crores)
2005-06	80548.98
2006-07	85494.64
2007-08	85494.64
2008-09	105600

Source: Ministry of Defense website (http://mod.nic.in/aboutus/body.htm#as6[17]).

Credit Expansion by Banks

Apart from governments, commercial banks can also increase the quantity of money without the corresponding increase in production of goods and services. This inflation banks bring about by using their system of *fractional reserve banking*. The process of creating money out

[17] Accessed on 1/19/2010 5:47:52 PM.

of thin air is famously known as *money creation*[18]. Today's banks can expand the money supply without any efforts because they work (and are legally supported and allowed to work in this way by the government) on the basis of the fractional reserve banking system. In this system, banks are not required to keep 100 per cent reserve deposits of the depositors with them all the time. They can (and they do) misappropriate money of the depositors, and use it to lend it to other people for making illegal profit out of it. Banks evolved basically as the warehouse for keeping people's deposits safe. Their only work was to safe guard people's money[19]. But, as slowly bankers realized that not all the depositors return at a time to withdraw their deposits, they started lending these deposit receipts, mixed up with other fraudulent pseudo-receipts, which are not backed by any reserves, to other customers in the form of loans and other such credit extensions. One example will make this point clear. Suppose, person A deposits 1000 rupees in bank X. Bank X knows that A is not going to return to withdraw his money until next two years. In this situation it sees an opportunity of using A's deposits to make illegitimate profit. It lends A's 500 plus extra 500 rupees of pseudo-receipts to person B and C at the charge of 10 percent interest rate for the period of one year. Person B and C will return 1000 rupees plus 100 rupees as an interest payment to the bank at the end of one year. In this way, banks pocketed 600 rupees of profit out of 1000 rupees of original deposit. 500 rupees it created out of thin air, without producing anything. This is how today's banks create inflation.

Cures of Inflation

After looking at the true causes of inflation, it is easy to see its cures. In following paragraphs I discuss what we need to do to stop inflation, and its malicious effects of price rise and booms and busts.

We now know that the *welfare warfare state* is the major cause of inflation. If anyone is serious about stopping inflation, then s/he must favor a total cut in governmental activities. Any step in the direction of total cuts in governmental activities will be an improvement in the direction of halting and eliminating inflation finally. Unless and until we do this, it is impossible to cure inflation.

[18] To further understand how today's commercial banks create money out of thin air through the process of money creation, please refer to, (Rothbard, 2004, pp. 805-809). Also see, (Samuelson & Nordhaus, 1998, pp. 477-481).
[19] For a detailed analysis of the vital economic difference between a deposit contract and a loan contract please refer to Soto's brilliant work (Soto, 2006). Also see, (Mises, 2009).

The fractional reserve banking system is a second major cause of inflation. This system should be adjudged illegal because of its fraudulent nature. All the *deposit banks* should function on the basis of 100 percent reserve standard. The activity of lending money to the businessman and needy people should be left over to the stock markets and/or *credit banks*, where explicit contracts about how the bank is going to use their money are signed between the depositors and the banks.

Central banks should be abolished because this is the institution which helps the fraudulent banks to survive when they go broke because of reckless embezzlements. In the absence of central banks and their bailouts, all banks will behave prudently in keeping their reserves in tact so that they do not default on their deposit payments. Central bank is also the institution which prints money for the welfare warfare government, and thus it should be dismantled as soon as possible[20].

Today's *paper* money standard allows governments, central banks and the banking industry to create money out of thin air. The cheap paper money can be printed endlessly. We need to stop this. Adopting the market based commodity money, such as Gold or Silver, will take the endless paper money source away from the fraud governments and banks. Market based Gold standard with 100 percent reserve requirement is the real solution of inflation.

Above outlined steps can only safeguard people's standard of living against the vicious inflation. No other options are open for mankind to stop the inflationary policies of the governments, the fraudulent banks and other such *money cranks*, who think that by printing money they can make people rich! To blame speculator, hoarder etc., for inflation is a trick of the establishment for covering up their sins and diverting people's attention[21]. By blaming these people, governments silently continue their inflation. On one side the government (all the parties, without exception) promises everyone that it wants to stop inflation, and on other side it continually breaks this promise. Populace can never understand these hypocrisies of government without a sound knowledge of the science of human action i.e., Economics. The Praxeological laws are necessary to understand, and fight inflationary governments and banks. Without this knowledge our world will never see an end of inflation.

[20] For the detailed arguments about dismantling the central banks please refer to Ron Paul's demolition of US Federal Reserve, (Paul, 2009).
[21] For a brilliant critique of such attempts of blaming speculators etc., for inflation please read Walter Block's *Defending the Undefendable* (Block, 2008) .

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