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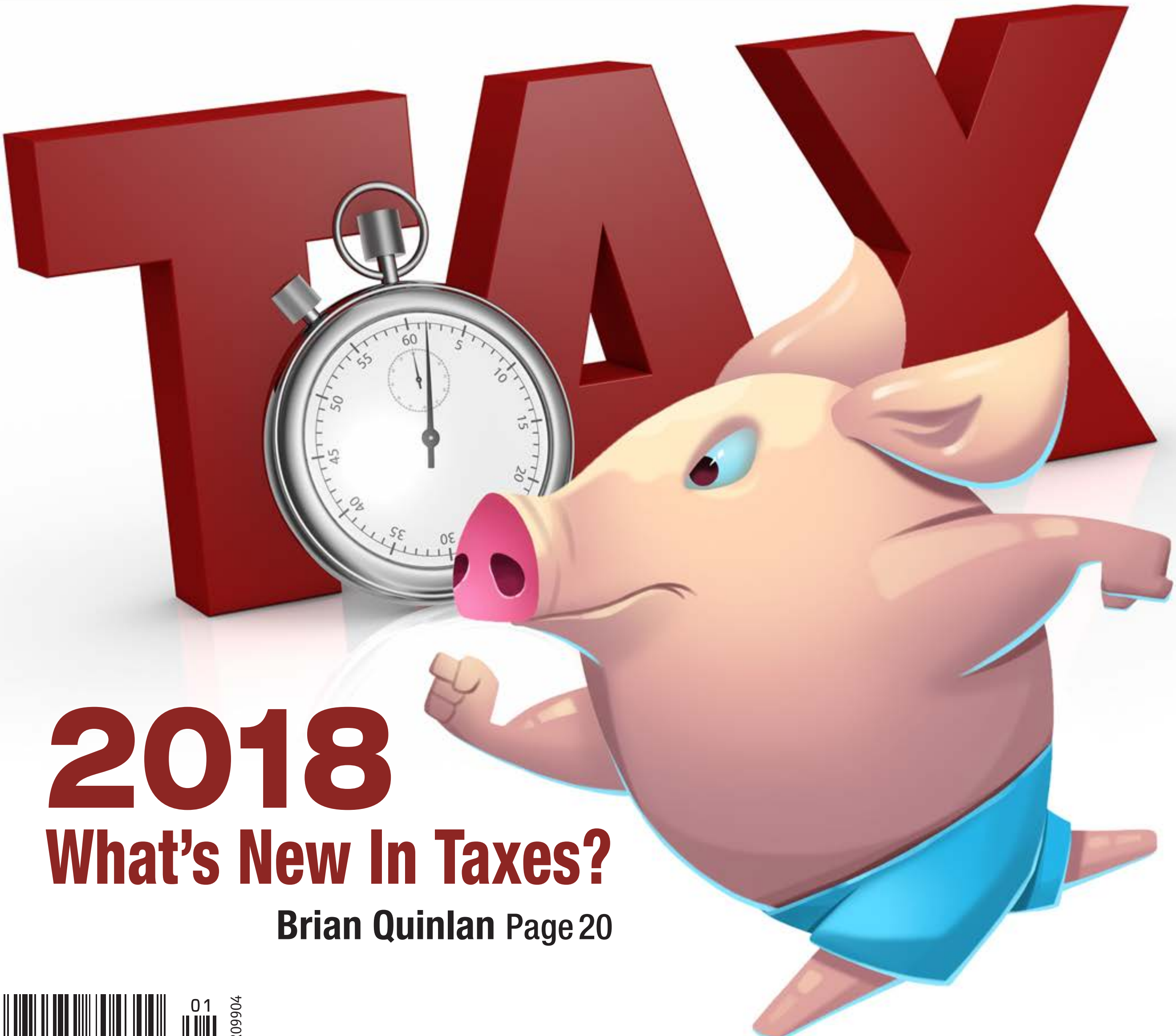

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Inflation, The Disease Of Money

Brian Chang

There is perhaps no economic subject more widely discussed today – nor more widely misunderstood – than that of inflation. While government economists are certainly aware that the unfettered printing of money will in the long run result in higher inflation, what they fail to realize is that rising consumer prices are only one of the many consequences of a sustained and widespread increase in the money supply. The central fallacy and the seed from which nearly all of today's major economic policy failures stem lies not in the higher prices themselves, but in the non-uniform way in which these higher prices propagate throughout the economy. Rising prices are not the problem per se, but only a symptom of the larger problem.

Let us imagine that some sum of money is simply printed into existence and given to the bankers at *Greedy Bank Ltd.* At the moment the bankers receive the new funds, prices in the economy have yet to increase at all. The bankers receive the immediate benefit of the new money and enjoy increased purchasing power over what they would have otherwise had if the money had never been created. As the bankers begin to spend their newly printed money on, say, steak dinners, the wages of the cooks at *Steakhouse Ltd.* begin to rise in line with the prices of the goods they produce while the goods that they purchase have yet to rise at all. At the moment that prices have risen for the food produced by *Steakhouse Ltd.*, the small business owners of *Mom and Pop Ltd.* must now begin to pay higher prices for steak dinners while their wages have remained unchanged. The owners of *Mom and Pop Ltd.* are now poorer as a result of the money creation and the bankers and cooks are now wealthier. The standard of living has increased for the bankers and cooks at the expense of the small business owners of *Mom and Pop Ltd.* Indeed, under this scenario, the owners of *Mom and Pop Ltd.* may well be among the last to receive the benefits of rising prices for their goods and the accompanying increase to their wages.

In an exchange economy, it is important to remember that people do not trade money for goods; they trade goods for other goods. Money is simply the common medium used for exchange. A baker who produces bread and wishes to trade it for milk must first sell his bread for dollars which he then trades to the dairy farmer in exchange for the milk. But it should be obvious that the acquisition of milk would have been impossible for the baker if he had not first baked the bread. The transaction by which the bankers of *Greed Bank Ltd.* exchange newly created money for steak dinners is an exchange of "something for nothing". Since the bankers in this case did not actually produce real goods to trade for these steak dinners, the bankers received "something", and some group, somewhere down the line, is the ultimate recipient of "nothing" in the form of reduced purchasing power.

The fact that the process of inflation leads to the bankers becoming richer to the detriment of some other group can be applied at a more general level. In a modern economy, and indeed in any economy, it will tend to be the case that those groups closest to the source of money creation will benefit the most while those groups furthest away from the new money will suffer the most. Under a process of continual inflation, those groups who permanently position themselves closest to the newly created money will gradually find their standard of living rising relative to their peers. In modern times, this process has contributed to what is popularly referred to as "the rising wealth gap", "the 1 percent", and the "have and have nots". While government economists are no doubt aware of the rising disparity between rich and poor, few if any will realize that many of today's ailments are merely a manifestation of past inflation which they themselves helped to create.

But the problems do not stop there, for the effects of the inflation now take hold in a more insidious manner. The exchange of something for nothing sets in motion a chain of false price signals throughout the economy, undermining everywhere the factors of production, leading to widespread waste and mal-investment, stimulating the overexpansion of ailing business, and destroying the real wealth of successful enterprise.

Suppose for example that *Steakhouse Ltd.*, being in the restaurant business, routinely offers its customers poor service, tasteless food, and over-priced wine. It should be no surprise that *Steakhouse Ltd.* finds its profit margins squeezed and one day finds itself on the verge of bankruptcy. Because of their close proximity to the establishments of *Steakhouse Ltd.*, the bankers of *Greedy Bank Ltd.* have a natural tendency to dine at its restaurants and begin to spend their newly created money in earnest. *Steakhouse Ltd.*, seeing the sudden increase in demand now concludes that its food and service is at last being recognized as exceptional and begins to expand its business to satiate the increased demand. Now begins the chain of events that distorts the factors of production in a thousand different ways that cannot be known in advance by anyone, least of all the government economist.

As *Steakhouse Ltd.* begins to expand it must hire more cooks, thus bidding up the wages of cooks accordingly. Now *Crabshack Ltd.*, which is also in the restaurant business, finds that in order to keep its own cooks it must raise the wages it pays, thus lowering its own profitability. The end result is that *Crabshack Ltd.*, which was in the first place making handsome profits, now finds itself with heavy losses. Where *Crabshack Ltd.* was before an efficient producer, generating a needed service at a profit, it now finds itself on the verge of bankruptcy and is soon forced to close its doors forever. If we suppose that *Crabshack Ltd.* served primarily seafood, then its misfortunes will not be lost on the fisherman who provided *Crabshack Ltd.* with the crab, who now finds business curtailed and is forced to reduce his own fishing fleet accordingly. The beef farmer, on the other hand, with the increased demand from *Steakhouse Ltd.*'s added steak menu and the rising profits from selling beef, decides it profitable to slaughter more cows that would otherwise have been used to produce milk. But this now raises the cost of milk to the average person who responds by buying fewer eggs, which in turn reduces the profits of the chicken farmer, and so forth until the distortions have at last been propagated throughout the entire economy.

But the catalyst for this whole process, namely the newly created money given to the bankers at *Greedy Bank Ltd.*, will eventually come to an end once the money has at last been spent. Once the mal-investment is finally revealed the process reverses and *Steakhouse Ltd.*, now seeing that the demand for its services was in fact artificial, is forced to shrink production, laying off its cooks and thus bidding down their market wages accordingly. Next is the beef farmer who, having found that he has led too many of his cows to slaughter, must now begin to slash beef prices dramatically to clear the inventory he had thought was legitimately demanded by *Steakhouse Ltd.*

If the unwinding is allowed to continue then the causal chain that was set in motion will over time be reversed, and resources will once again be re-allocated in their proper proportions. But it can be seen that the human costs of doing so will become immediately apparent to politicians and socialists everywhere. In order to prevent the unemployment that follows the artificial boom created by the inflation, the money supply will again be expanded in favour of some other group, thus re-igniting the misallocation of resources that gave rise to the first artificial boom and subsequent bust. The compounding of error upon error will over time magnify the original problem a hundredfold, making the inevitable bust all the more painful and the transitional unemployment all the more severe.

And yet the above appears to be completely lost on the average economist of our day, who continues to fight the symptoms of the problem with the same bad medicine. It is not the rise in consumer prices which is ultimately significant, but the increase of the money supply which preceded it. The myopic focus on rising prices misses the point entirely, presuming that rising prices are the only harm that comes from the printing of money with reckless abandon. Central planners, because of their misunderstanding of the inflation process, are in fact the very cause of the boom-bust cycle we see today. The fact that they have spent the last decade redoubling their efforts to inflate away the currency leaves no doubt that any sustained economic recovery is merely a pipe-dream of the optimists. Instead, the structure of production continues to rot away, hidden from view, laying the seeds of higher prices which the average economist will at last, finally, be able to recognize.

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