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You're Poorer Than You Think

Brian Chang

Most people today have grown accustomed to the gradual yet persistent increase in the overall cost for goods and services, yet very few realize the true extent to which their purchasing power has been steadily eroded over time. Because the vast majority of the population has rarely, if ever, lived through economic conditions where overall prices in aggregate have failed to rise on balance each and every year, the average person has little notion of the natural state of an economic society unburdened by a continuously increasing money supply. It is precisely because the general population has never lived through a period of generally falling prices that they do not readily recognize that deflation—an increase in the value of money and decrease in general prices—is the true state of an economy unencumbered by the perpetual expansion of the money supply.

Since all the money in an economy is used to bid on all the goods and services produced, it is often said that an increase in general prices is caused by "too much money chasing too few goods". By way of a simple example, let us imagine the fictional economy of Widgetlandia whose total economic output is simply one million widgets and nothing more. Let us also assume that Widgetlandia has a total money supply of one million dollars spread between its various citizens. Over time, with a million dollars bidding on a million widgets, it will tend to be the case that each widget will eventually arrive at an equilibrium price of approximately one dollar per widget. Suppose now that the money supply is increased to two million dollars and the amount of widgets produced is unchanged. It will, over time, be the case that each widget will shortly be bid up to approximately two dollars per widget. Conversely, the opposite process accompanies a decrease in the money supply in that less money chasing the same amount of widgets results in a decrease in the price of widgets.

But the above example focused only on one half of the equation, the money supply. There is of course another part of the puzzle, which is the number of widgets in the economy that the money is bidding for. Suppose now that Widgetlandia suddenly undergoes an increase in productivity so it is now able to produce two million widgets, with a money supply still of a million dollars. With a million dollars now bidding on two million widgets, each widget will tend to find an equilibrium price of fifty cents. The cost of a widget has thus decreased due to real productivity improvements which has correspondingly increased the purchasing power of the citizens of Widgetlandia and with it, their overall standard of living. Society has been made unquestionably richer as a result of economic progress since there are now more widgets to be had, and each for a cheaper price.

In the modern economy we live in today, the growth of the money supply has virtually always outpaced increases in productivity, which is why the overall trend of prices has almost exclusively gone up, and very rarely down. This, of course, does not preclude a drop in prices for some specific individual consumer goods or services. It is clear, for example, that certain categories of goods such as consumer electronics have, in fact, experienced significant price declines due to human innovation and improvements in the various factors of production. This only means that increases in productivity in these specific areas has been so rapid so as to more than offset the economy-wide increase in the money supply, but overall, this cannot be the case across the entire economy. While relative prices of certain goods may either increase or decrease regardless of changes in the money supply, as long as the quantity of money in circulation is increasing at a faster rate than economic growth, general prices must always increase over a sufficiently long period of time.

It is a poorly kept secret that the use of inflation has historically been used as a mechanism to lower real wages while maintaining the mirage of nominal wages. In other words, inflation is often used to disguise the fact that while a person may receive the same dollar salary this year as they had the year prior, they have effectively been given a pay cut by businesses as employers decrease real wages simply by maintaining salaries at existing levels. During times of economic recession, this lever has proven to be an immensely useful policy tool for central planners, as dollar wages are sticky and hard to change, while the gradual erosion of employee salaries through stealth has historically proven to be a far more palatable option.

But the population and society at large are not so dim to the government's tricks. They know that prices seem to rise by the rate of inflation every year, and aggressively negotiate salary increases to keep up with the rising increase in consumer prices. An officially reported inflation rate of, say, two per cent results in union's negotiating a two per cent "cost of living" adjustment into their salary demands and causes workers to insist on pension payments and certain benefits increasing annually be two per cent as well. But in demanding only a two per cent mandatory increase the workers and unions have been fooled yet again, for they are basing their calculations of the loss of purchasing power on the value of last year's wages which they have come to firmly anchor in their minds. They have not realized that their wages would have increased in value through natural economic progress and have therefore once more found themselves shortchanged by roughly the rate of increased productivity growth.

If economic growth, for example, comes to average about three per cent per year, then this is the approximate rate by which the standard of living would come to improve for the majority of people had no new money been created at all. In an economy free from the shackles of unending money creation, worker purchasing power would have increased by three per cent rather than decreased by the inflation rate of two per cent. If the price of goods and services becomes two per cent more expensive in the face of economic growth of three per cent, it is only because enough money-printing has taken place to completely offset the three per cent decline in prices, in addition to adding on a two per cent increase in prices on top of that. This results in a total devaluation of money of approximately five per cent, not the two per cent that was initially thought.

And yet it is only the two per cent erosion of their salary based upon last year's wages that most people consider in their calculations, when, in fact, their purchasing power has been reduced by five per cent when measured from a different starting point. But the average person rarely considers this hidden reality, for they care only that their wages will buy them the same thing tomorrow that it does today, not what it theoretically could have bought had all the past money-pumping never taken place at all. Further still, even if workers and organized labor attempted to negotiate a total five per cent increase in wages to make up for a lack of falling prices, no government or business would acquiesce to such demands. For it is impossible to argue that a person should be compensated for the absence of a benefit that can scarcely even be seen, much less calculated.

But if the value of money has in fact been eroded by five per cent instead of the widely assumed two per cent reported through the official rate of inflation, then this three per cent difference represents an additional unexpected reduction in money's purchasing power of approximately 25% over a period of 10 years. This is profoundly damaging to both incomes and savings over the course of the average worker's lifetime and constitutes yet another way that average people have been surreptitiously impoverished by the realities of the present-day monetary system. Yet even if it were possible to determine the precise rate at which general prices increase from one year to the next, it is folly to believe that this represents the true extent by which societal purchasing power has declined over time. The hidden costs of inflation constitute an implicit tax that simply cannot be statistically measured. It is a form of theft by stealth. It is insidious. It serves only to erode the real value of savings to the ultimate detriment of society.

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