William H. Peterson

INFLATIONISM

. . . there is no subtler, no surer means of overturning the existing basis of Society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction and does it in a manner which not one man in a million is able to diagnose.

So observed John Maynard Keynes, member of the British delegation to the Paris Peace Conference, in his book, *The Economic Consequences of the Peace* (1919). Within four years, a vicious hyperinflation had thoroughly debauched the mark, overturned the existing basis of German society and prepared the way for a Hitlerian *Götterdämmerung*.

Lord Keynes' observation is not without irony. Later Keynes was himself to become enraptured with the idea of inflationism—to become, it would appear from the record, the most powerful if inadvertent advocate of that creed in the Twentieth Century.

What is inflationism? I see it as a social mirage, the modern-day version of the ancient search for the philosopher's stone that would transmute lead into gold (or "stone into bread," as Keynes put it in 1943), the hope for a social perpetual motion machine, the wish come true of King Midas for all he touched to turn into gold (only to find he could then neither eat nor drink).

Inflationism, in today's terms, is deficit-spending, deliberate credit expansion on a national scale, a

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public policy fallacy of monumental proportions, of creating too much money that chases too few goods. It rests on the "money illusion," a widespread confusion between income as a flow of money and income as a flow of goods and services—a confusion between "money" and wealth. As Adam Smith observed in his *The Wealth of Nations* (1776):

> That wealth consists in money, or in gold or silver, is a popular notion which naturally arises from the double function of money, as the instrument of commerce, and as the measure of value. . . . To grow rich is to get money; and wealth and money, in short, are, in common language, considered as in every respect synonymous.

Today prosperity has become but a matter of alleviating the "shortage" of money, of making money—literally. And not, primarily, of making goods and services.

For Keynes, inflationism was an idea whose time had come, coming as it did during the Great Depression when people and politicians were desperate for solutions, almost any solution. Besides, the Keynesian solution was not clothed as inflationism but as a means of relieving inadequate aggregate demand with "temporary" or "contra-cyclical" deficit-spending, of attaining a balanced budget over a business cycle, over a cycle of years.

But the way things worked out, the legacy of Lord Keynes has become national deficits ad infinitum pretty much the world over.

Economists James M. Buchanan and Richard E. Wagner of the Center for Study of Public Choice at the Virginia Polytechnic Institute decry mounting deficits in America, each one seeming to make yet another entry for the Guinness Book of World Records. In their *Democracy in Deficit: The Political Legacy of Lord Keynes* (Academic Press, 1976, 207 pages, $11.50), Buchanan and Wagner link Keynesian-type deficits to rising inflation, heavy unemployment, expanding government, lagging capital formation and generally deteriorating economic performance.

More importantly, as may be gathered from their subtitle, the Buchanan-Wagner critique of Keynesian economics is not so much on its technical structure as on its *political* implications, on how these implications have long impacted on economic policy decisions since the Great Depression—decisions adding up to the global Keynesian Revolution.

The General Thesis

In a nutshell, what are the Revolution's technical underpinnings all about? In his *The General Theory of Employment, Interest and Money* (1936), Lord Keynes advanced the possibility, if not probability, of an underemployment equilibrium in a mature national economy such as Great Britain or the United States. He described a gloomy scenario of a depression long persisting without any effective automatic stabilizing market forces. He saw aggregate employment as a function of aggregate demand (total spending), which tended to contract cumulatively—unless somehow counteracted. Keynes' approach was strictly macroeconomic, or to use the equation popular with Keynesians today: **Y = C + I + G**, or total national income equals total consumption spending, plus total investment spending, plus total government spending.

The cause of depression would be private sector oversaving or underspending (underconsumption and/or underinvestment). Hence Keynes saw **G** as a *deus ex machina* in which government could simply furnish spending stimulus as needed. The stimulus, which could apparently be turned on and off like a faucet, would happily restore full employment; and it would be greatly aided by the operation of a chain-reaction effect on total income, a cumulative, circulatory expansion of aggregate demand—Keynes' famous "multiplier."

It is to the credit of Professors Buchanan and Wagner that they break new ground in more than four decades of Keynesian critiques, that they perhaps get to the heart of the problem in the entire Keynesian structure: the assumption of apolitical economic managers, of an intellectual ruling elite, of selfless men in high places dedicated solely to the public interest.

Unbalanced Budgets

As the record shows, this assumption of political altruism has proved to be most unreal in application, from Tokyo to Ottawa, from Stockholm to Buenos Aires, for the Keynesian-oriented world has long been awash in red ink, in perennially unbalanced national budgets. In the clash of pre-Keynesian economics versus post-Keynesian politics, the VPI economists observe that politics wins practically every time.

The Washington experience is a case in point. To be sure, U.S. economic managers, and their counterparts elsewhere, have had to assume an aura of economic omniscience so as to decipher lagging and frequently conflicting economic statistics, to "fine-tune" the economy, to produce just the right mix of fiscal and monetary policy under ever-changing economic conditions. Such an economic challenge is task enough; in a political environment with a national election in every even-numbered year, the challenge amounts to, apparently, an impossibility.

To wit: The officially projected deficit of $64.7 billion in the 1978 fiscal year beginning Oct. 1 (the 17th deficit since 1960) comes atop an estimated inflation-generating $52.6 billion deficit this fiscal year.

Why? Why deficit upon deficit, world without end? The answer, in a word, is politics, in a letter, **G**.

Significantly, the VPI economists distinguish between market competition and political competition, a distinction Lord Keynes and his disciples did not develop. Market competition is continuous; at virtually every instance of purchase a buyer can choose from among different competing sellers. Political competition, in contrast, is discontinuous, intermittent; the voters' decision is binding for a fixed term—usually two, four, or six years. Market competition permits several competitors to survive at the same time; the capture by one seller of a majority of the market does not deny the ability of the minority to choose its preferred supplier. Political competition, on the other hand, has an all-or-none characteristic; the capture of a majority or even a plurality of a market basically hands over the entire market to a single supplier.

Nor do the distinctions stop there. In market competition, as Buchanan and Wagner note, the buyer can be reasonably certain of just what he has bought for his money. Not so in political competition, for there the buyer is, in a sense, obtaining the services of a rather free agent. This political agent cannot be bound in matters of specific compliance, with many a platform promise going awinging with the swearing-in ceremony.

A Bias Toward Inflation

Given such a political environment, the Keynesian provision of an elastic **G** is almost like giving a child free rein in a candy store. Professors Buchanan and Wagner hold that "the Keynesian destruction of the balanced budget constraint" on a year-to-year basis has yielded a political bias toward budget deficits, monetary expansion and public-sector growth. The bias ties into the politicians' natural proclivity to spend, to avoid taxing, to appear humanitarian, altruistic, munificent (with, of course, other people's money)—in effect, to buy votes. The bias also ties into the fact that the economic managers are, in every case, political appointees and, especially in the instance of the Federal Reserve Board, creatures of Congress; this means their ability to contravene their political superiors is correspondingly weak.

This politicalizaton of the Dismal Science in the halls of government seems to explain American fiscal and monetary experience since the

Great Depression. It seems to explain how economic theory and policy have developed in recent decades to meet, if not marry, political exigencies. The marriage, if that's what it is, has not been a happy one. A glance at recent decades of "managing the economy" illustrates this marital incompatibility.

In the early stages of the Great Depression (itself largely the product of credit expansion in the Twenties followed by credit contraction in the early Thirties), Franklin Roosevelt, as a Presidential suitor in 1932, ran on a balanced-budget plank and publicly decried GOP deficits ("continuation of that habit means the poorhouse"). Once in office, however, President Roosevelt soon found "pump-priming" expansion of spending programs politically popular, while tax increases were not. The balanced budget goal seemed more and more elusive.

Political Attributes

Moreover, along came Keynes' *General Theory*. Though addressed to academics and incomprehensible to almost all but professional economists, it was promptly perceived by politicians for its political value. Deficits became respectable. Spending programs and tax measures could be politically manipulated this way and that. A "flexible" budget, after all, has to play the main role in stabilizing the economy and sustaining "full employment." Baldly, inflationism was in.

The "full employment" concept was enacted into law in the Employment Act of 1946. The Act, which formally married economics to politics, directs the federal government to "use all practical means consistent with its needs and obligations ... for the purpose of creating and maintaining ... conditions ... to promote maximum employment, production, and purchasing power." The Act leaves Professors Buchanan and Wagner cold. They protest its political implications and believe that the Act "may come to be regarded as one of the more destructive pieces of legislation in our national history."

They see, for example, how the Eisenhower Administration played a reluctant spouse in the Keynesian marriage between political practice and economic theory. The GOP came into office to do something about inflation and the growth of Federal spending, only to come under Democratic fire for "fiscal drag." The Republicans lost the White House in 1960, after losing the Congress in 1954 (which hasn't been regained since).

Initially President Kennedy was also something of a reluctant spouse, but, note the VPI economists, his economic counselors were, to a man, solidly Keynesian.

The counselors, who included Walter Heller of the University of Minnesota and John Kenneth Galbraith of Harvard, apparently won a complete convert in JFK after the 1962 steel pricing confrontation and consequent stock market slump. In 1963 President Kennedy called for a dramatic tax cut, without any corresponding spending cut, in order to accelerate economic growth and bring actual GNP in line with *potential* GNP, given the productive capacities of the nation. With the tax cut, enacted in 1964, the New Economics had really arrived, but hard-nosed politics had long preceded it.

In this new dawn it seemed that "the enlightened would rule the world, or at least the economic aspects of it," to quote Buchanan and Wagner. Then they add: "But such dreams of Camelot, in economic policy as in other areas, were dashed against the hard realities of democratic politics."

Redistribution Schemes, Open-Ended Spending

The hard realities included the redistributionist zeal of Lyndon Johnson's "Great Society" augmented by his Vietnam guns-and-butter strategy, and Richard Nixon's New Economic Policy of wage/price controls (which quickly became a cover for the fastest monetary growth since World War II—12.1 per cent in election-year 1972).[1] The realities also included the open-ended spending proclivities of the Welfare State and the no-growth implications of Ralph Nader, the Sierra Club, Common Cause, and Senator Edmund Muskie's Environmental Protection Agency.

The Keynesians also overlooked some economic as well as political realities. Probably the most devastating reality has been the unprecedented worldwide experience of "stagflation"—heavy inflation cum heavy unemployment. In the U.S., inflation was 12.2 per cent in 1974; in 1975 unemployment was 8.5 per cent. How did this happen? The VPI authors cite some economic reasons.

For apart from its political naivete, the New Economics can be faulted on at least three technical grounds. First, the Keynesians

[1]From Ludwig von Mises, *Planning for Freedom* (Libertarian Press), page 81: "The superstition that it is possible for the government to eschew the inexorable consequences of inflation by price control is the main peril. For this doctrine diverts the public's attention from the core of the problem. While the authorities are engaged in a useless fight against the attendant phenomena, only few people are attacking the source of the evil, the Treasury's methods of providing for enormous expenditures. While the bureaus make headlines with their activities, the statistical figures concerning the increase in the nation's currency are relegated to an inconspicuous place in the newspapers' financial pages."

have relied on the money illusion—the notion that fiscal-monetary stimulus would yield a beneficial "automatic lowering of real wages as a result of rising prices" (*General Theory,* p. 264). But in a world in which inflation is widely anticipated by market participants through escalator clauses, increased wage demands and inflation-hedged price boosts, the money illusion breaks down. Indeed, Buchanan and Wagner note that "the generation of inflation that has been predicted will do nothing towards stimulating employment and output."

Secondly, the Keynesians overlooked the impact of inflationism on economic calculation and resource allocation—a possible general disruption of the market economy, perhaps a full-fledged business cycle. Relative prices, including interest rates, are distorted, unevenly, by rapid increases of the money supply entering the economy at different times and in different ways and places. Market participants receive false signals. For example, corporate income statements reflect "phantom profits" which do not incorporate true inventory valuations and especially plant and equipment replacement costs; moreover, reported "record profits" are expressed in current, inflated dollars and not in constant dollars.

Thirdly, Keynes and the Keynesians overstress macroeconomics to the detriment of vital microeconomic considerations. This leads to a one-dimensional, depthless perception of the forest but not of the widely different individual trees. G is perforce a heavy-handed economic policy instrument—taking such diverse, discrete forms as dams, defense projects, welfare programs and so on. Financially, G poses quite a drain on capital markets—and private capital formation—a "crowding-out" of private borrowers through higher interest rates.

Unemployment Realities

This strictly macroeconomic view of things leads to the glossing over of still other problems, including the microeconomics of unemployment. In the case of structural unemployment, for example, the authors observe in a footnote that government spending may act to cement pockets of unemployment "into quasipermanence." Or consider the problem of properly defining full employment, traditionally set at 4 per cent. Now it turns out that 4 per cent is much too low, and may have been so for almost the last 30 years.

Economist Robert Hall of the Massachusetts Institute of Technology, for example, says that the sustainable rate of unemployment, below which inflation begins to escalate, was around 5 per cent in 1948 and has slowly risen to between 5½ per cent and 6 per cent in recent years. This rise, reflecting in part the influx of women and teenagers into the labor force, seems to mean that economic managers have long been working with a fallacious policy goal. Nonetheless, the Humphrey-Hawkins national economic planning bill, the Full Employment and Balanced Growth Act of 1976, went beyond the 4 per cent goal and mandated a quixotic unemployment target of 3 per cent, to be attained within four years.

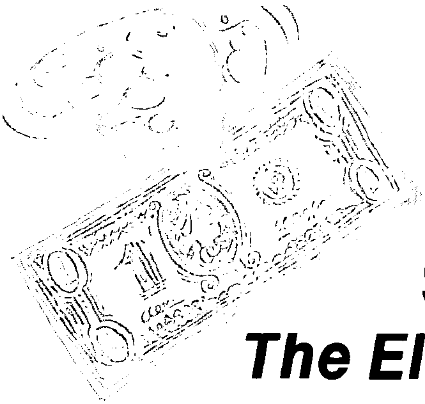
Balance the Budget

Well, what is the solution to stagflation and related ills? James Buchanan and Richard Wagner believe the heart of the problem lies in "the political legacy of Lord Keynes." They believe the solution lies in virtually banishing peacetime deficit-spending. They call for, as do Senator Carl Curtis of Nebraska and Congressman Bill Archer of Texas, a Constitutional amendment requiring an annually balanced budget, except in a national emergency (as declared by two-thirds of both Houses of Congress and approved by the President). Their solution merits serious consideration.

In any event, the timely Buchanan-Wagner book focuses attention on the overriding economic paradigm of our age: government intervention to "improve" free market performance. This is a paradox, for government is more often the problem than the answer. In the case of Keynesian theory and policy, maybe Prime Minister James Callaghan of Great Britain, the land of Lord Keynes, has the last word on inflationism in his address to his own Labor Party last fall:

> We must ask ourselves unflinchingly, what is the cause of high unemployment? Quite simply and unequivocably, it is caused by paying ourselves more than the value of what we produce. This ... is an absolute fact of life, which no government, be it left or right, can alter.... We used to think you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candor that that option no longer exists, and that insofar as it ever did exist, it worked by injecting inflation into the economy. And each time that happened the average level of unemployment has risen. Higher inflation, followed by higher unemployment. That is the history of the last 20 years.

William L. Baker



Inflation and Stabilization— *The Elusive Promise*

MOST "free marketers" understand that inflation is the increase of the money supply. In other words, inflation is wholly a government-sponsored blessing. A lot of people, who otherwise believe in a free market economy, feel that a "certain amount" of inflation is necessary. Otherwise, they state, there would not be enough money to buy the goods generated by increased production in a dynamic and expanding economy. Besides, they argue, the "price level" should be kept stable. Thus, some governmental interference is warranted even in a free market.

But just how true are all such assertions?

The "not-enough-money" concept has been around for a long time. It was popularized on a grand scale by John Law, the Scottish-turned-Frenchman central banker, when he propagated his inflationary schemes at public expense. The theory was that so much money would buy just so much goods. Beyond that, no further production was possible without an increased supply of money.

This monetarist approach simply ignores the demand side of money while stressing the supply side. In reality, as production increases in an economy with a static money supply, prices will simply tend to drop. Competition or demand for money becomes more fierce. The result is a monetary unit that continually enhances in value. Supply and demand works for money just as it does for apples and pears. There is always a sufficient amount

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