

# Inflation—What Is It?

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TO THE average American, inflation means a sharp, uncontrolled rise in prices with the dollar rapidly losing its purchasing power. He conjures up frightful pictures of the Continental currency, the French Assignats, the Greenbacks and the German Mark. Of its origin and its real nature, he has only a vague idea. There are different kinds and degrees of inflation, and unfortunately, there is no general agreement among economists either as to the kinds or as to the effects. Consequently, the subject to a large extent still remains in the theoretical stage. The same statistics are frequently presented to prove both sides of a controversy. A distinction is made between price inflation and money inflation by some economists; but as any extended explanation of this may serve only to confuse the reader, we shall refer to inflation as meaning a rise in the general level of commodity prices.

While price inflation may refer to a rise in the prices of particular commodities (such as farm products, which have gone up 75 per cent since August, 1939, while the prices of other commodities have risen only 19 per cent), fluctuations in the general level of prices are not caused by factors on the commodity side, except possibly in an indirect fashion, but by the contraction or expansion of money supplies, the term "money" being used here to include not only currency but also bank deposits, mercantile ledger accounts and all varieties of credit instruments.

The general price level is essentially a monetary concept. Inflation occurs when the supply of money increases faster than the output of goods and services. This simply means that purchasing power of money demand is greater than the supply of things that can be bought. However, an increase in the mere quantity of money cannot affect the price level. Idle bank deposits, for instance, can exert no direct influence on prices. They must actually reach the commodity market. Therefore, money supplies consist of the quantity of money multiplied by its velocity. During more or less normal times, a rising price level is no indication that the total supply of goods has decreased but rather that the supply of money has increased in a greater ratio. And a falling price level does not mean that the supply of goods has increased but rather that money supplies have been curtailed. This explains why prices in 1932 were so low when production was at a minimum. Banks and commercial concerns had been gradually restricting credit for over three years. We cannot attribute a low general price level to low costs of production, for we observe that during periods of great technological progress the price level does not always fall. The price index for 1850 was practically the same as for 1910 in spite of the amazing degree of progress during that period. And from 1895 to the World War, prices actually rose

even though a great deal of technical progress took place in that time.

## Normal and Abnormal Inflation

In spite of the mass of conflicting opinions and theories on this subject of inflation, there are certain basic principles that can guide us to a practical understanding of it. Broadly speaking, there are two kinds of inflation. One is normal or natural, and the other is abnormal or spurious. The first arises out of the market as a result of business activity. The second is caused by factors outside of the market. The normal kind generates its own correctives, and wages, salaries, rents and profits move in conformity with the rise in the price level. This does not mean that they necessarily all move simultaneously, for it takes time for adjustments to be made; but it means that so long as no burdens obtrude upon the market, such as restrictive legislation or political action, the tendency is for the relationships prevailing among the various groups of producers to shift according to supply and demand. As long as the production of goods and services can be increased in response to the money demand, the rise in prices is held within reasonable bounds. And even when the limits of the capacity of labor and capital are reached, the money supplies generated by private business concerns and individuals are automatically checked. Money is created every time that one individual gives an order for goods or services and another accepts it at a price. The more of that kind of activity there is, the more money there is, except possibly during periods of depression when confidence is lacking. The less activity, the less money in circulation. Thus a reciprocal relationship exists between goods and money, and the tendency is for the supply of goods to keep abreast of the money supply. However, during periods of progress, there is a tendency for the supply of money to run slightly in advance of the supply of goods, and the result is a rise in the general price level.

Money is also created by the banks when they increase their deposits through loans to individuals or corporations. These deposits circulate in the form of checks or currency. And again in this case, excessive supplies of these circulating media are avoided by automatic curbs. As the banks expand the volume of money, the disparity between their time and demand deposits and their cash reserves steadily grows until the legal ratio is reached which is generally considered to be the margin of safety. The result is that the banks begin to curtail the extension of credit and the volume of money is checked. But whether or not the legal ratio is reached, the necessity of exercising reasonable care in selecting their credit risks in order to conserve their capital automatically controls the money supply.

Business men themselves also affect the money supply when they refrain from applying to the banks for loans as the interest rate rises. Producers and exchangers of goods and services cannot afford to be profligate in their use of credit, for unprofitable operations are reflected in their balance sheets. The market acts as a check on irresponsibility. Thus the overproduction of money in normal times creates its own correctives and serious inflation is avoided. Furthermore, inflation is usually corrected if it is confined to any particular country, because rising prices in that country above the world level tend to increase imports into it and check exports from it. In this way, goods flow into the country and alter the disproportion between goods and money.

The other kind of inflation—the spurious variety—occurs under abnormal conditions. It arises not from the normal activity of the market but out of depressions and wars and exerts an arbitrary pressure upon the market. It is caused by the actions of government and is the kind that strikes terror into the hearts of the people. No automatic check inheres in it, for government is not deterred by considerations of profit or loss. Government does not rely on the market for its livelihood but on taxation, and so there is no automatic curb on its profligacy aside from that exercised by the character and intelligence of the politicians and their constituents.

Since 1929, thoughtful people in this country have feared a runaway inflation, as they watched with apprehension the building up of a huge public debt and the spending of billions of dollars by the government. They knew that monetary history showed that inflation usually resulted from accumulating budgetary deficits, and that if such deficits were continued long enough, serious inflation was inevitable. Of course, there are two kinds of public borrowing. When individuals buy government bonds or notes, there may be no addition to the general purchasing power of the country, if resort is not had to bank credit or to idle funds, in order to finance such purchases, for the result might be merely the transfer of funds from one group to another. But when the government sells its bonds to the banks, deposits are created, and these new deposits are potential currency. When this currency reaches the markets, the purchasing power of the public is expanded. Prices rose since 1932, but to what extent the rise was due to public spending or to what extent it was due to the natural forces of recovery, it is impossible to determine. Certainly they did not rise as high as the alarmists had expected nor, on the other hand, did the prosperity materialize that the inflationists had predicted.

We need not consider seriously the absurd claim that deficit financing could produce prosperity by raising prices; but it is natural to inquire how it is that although a fifty billion dollar debt had accumulated before this country entered the present war, no serious inflation had occurred. Undoubtedly an increase in money supplies from such a source could not be met by a corresponding increase in production, and prices would ordinarily rise at the expense of those who worked in private

enterprise. But part of the idle labor and capital responded to the increased demand, and the resulting addition to the supply of goods tempered the rise in prices to some extent. Then again a portion of the deposits created by the banks probably was used to provide necessary public improvements that facilitated the production of goods, permitting an addition to the supply of goods in proportion to the increase in purchasing power. Furthermore, all of the borrowed money did not reach the commodity markets. Much of it was placed in numerous lending agencies such as the Reconstruction Finance Corporation where it lay idle, because responsible business men availed themselves of it only as they considered it profitable to do so. Of course, the funds that were used to support the indigent and to subsidize various pressure-groups undoubtedly exerted considerable pressure on the price structure, for they could not possibly call forth a sufficient increase in the supply of goods. Yet unless the flow of new funds was continuous, the rise was short-lived. Such was the experience in connection with the payment of the soldiers' bonus in 1936. Production was stimulated by the increased demand, but this soon petered out. And at the same time, this spurious inflation was offset to some extent by the recapture of part of the new funds through increased taxation. Moreover, it must be remembered that while the government was frantically trying to raise prices, it was at the same time pursuing a decidedly deflationary policy by discouraging and hampering business with heavy taxes, onerous regulations, restrictive labor laws and rulings and general all-around threats and abuse. Business was kept in a constant dither of suspense and uncertainty. Although in 1936 industry boomed and wages and profits were higher, by the middle of 1937 it slumped again. And in 1938 the outlook was so black that it is difficult to say how long the slump would have endured had not the war demand from Europe the following year given production here a much-needed impetus.

### War and Inflation

The start of the lend-lease program by which this country established itself as the arsenal for the democracies, signaled again the danger of serious inflation. Our own entrance into the war magnified the danger when borrowing and spending continued at an accelerated rate. History shows us that when an expansion of the currency produced widespread disorganization, poverty and misery, it was always associated with wars, revolutions, preparations for war or the consequences of war. One very important reason for this is that war spending is qualitative rather than quantitative, for production is diverted from peace goods to war goods. War spending increases consumer income, and so we have increasing money supplies on one hand bidding for decreasing supplies of peace goods on the other.

To gain an idea of the magnitude of our war effort, we might consider these facts:

According to the Chairman of the War Manpower Commis-

sion, an additional 10,500,000 workers will be required in war industries by the end of this year and 7,500,000 during 1943. Most of them will come from converted and curtailed civilian industries. War expenditures are expected to reach \$26 billions for 1942 and \$67 billions for 1943 as against expenditures during the last war of \$11 billions for 1918 and \$14 billions for 1919. The total public debt for 1943 is estimated at \$125 billions compared with \$25 billions in 1919. It would be desirable for the war to be financed as much as possible out of current income, but politicians usually take the easy way of borrowing rather than brave the wrath of their constituents.

Although England during the first three years of the World War depended more on taxation than any other nation, at the end of that period she had paid less than 20 per cent of the war's cost out of taxes. In the Napoleonic and Crimean Wars she paid 47 per cent out of taxes. Despite the fact that our own government is collecting more in taxes than in the last war and has estimated new taxes for 1943 at \$7 billions, the deficit that will have to be financed by borrowing for that year is set at over \$49 billions. And although it expects a rise in receipts to more than three times the largest total of any year prior to 1941, borrowings contemplated for 1943 alone are nearly twice the total borrowing of the last war. Most of this financing is being effected through expansion of bank credit which will add to the purchasing power in the market. Compared to the last war, our financing record is poor. Then the non-banking public financed 73 per cent of the World War debt increase and the banks 27 per cent. For the three years, 1941-43, the war costs are expected to be financed 46 per cent by the non-banking public and 54 per cent by the banks. Not only is this heavy reliance on the banks a serious inflationary threat, as it is rapidly adding to the public's buying power, but it is placing a terrific strain on the banks which have been compelled to purchase government securities in the open market in order to build up their dwindling excess reserves.

Part of the purpose of increased taxes is to recapture the additional buying power which is pressing the price level upward. Strenuous efforts are being made also to mop up this excess by the sale of war savings bonds to the public, which has already increased four-fold. There are certain obstacles, however, to the purchase of bonds by the public in sufficient quantities. Whereas in the last war not over a fourth of the national income was devoted to war in any one year, over half is expected for 1943. Taxes also are higher, and interest rates are so low that the incentive to investment has been greatly weakened. Furthermore, the people have been taught during the past ten years to rely so much upon the government that they probably have lost some of their initiative.

The Office of Price Administration estimated the total buying power in 1942 at \$117 billions and taxes and savings at \$31 billions, leaving \$86 billions available for spending as against consumers' goods and services estimated at present prices at \$69 billions. The difference of \$17 billions represents

the inflationary threat. Not wholly confident of its attempt to pipe off the \$17 billions by taxes and savings, the government has tried to place a ceiling over prices in defiance of the lessons of history and overlooking the fact that low prices encourage buying. Where the ceilings squeeze the producer, subsidies are proposed. These will not only expand buying power, the very thing the OPA wants to avoid, but also add to the public debt. It should not be necessary to give the reasons why price-fixing will fail, for already the ceilings have been pierced in a number of cases, and the OPA has admitted its disappointment at the results. Although it might be possible to temper the rise in prices by rigid enforcement, provided wages and farm products are included, this could only be achieved at the expense of production. In fact, business has already been badly affected. This in itself may contribute to inflation, for it reduces the supply of goods and widens the inflationary gap. Moreover, any interference with production, even of peace goods, is inimical to the war effort, tends to prolong it and makes it more costly.

### The Road Ahead

Can we avoid disastrous inflation by heavy taxes and the buying of war bonds by the public? There are many signs that point to a negative answer. The new taxes are concentrated mostly on the medium and higher incomes, which furnish the bulk of the nation's capital, and on corporations, and so will tend to decrease production. Furthermore, larger receipts may not diminish the reliance on borrowing, for it may encourage the government to be more extravagant. Then again, a substantial part of the receipts must go to pay the interest on the public debt, including the \$50 billions accumulated during peace time. Another consideration is the tendency of the politicians to divide their attention between the war, social reforms and catering to pressure-groups, the order of the day appearing to be that we cannot have business as usual, but we must have politics as usual. Still another point to weigh is that we must continue the huge public spending long after the war has ended, for we have dedicated ourselves to policing and reforming the entire world and to feeding and rehabilitating the peoples of the devastated areas, in addition to providing for our own rehabilitation.

It may be possible for us to avoid a runaway inflation provided faith in the government's credit is not weakened. In the event the interest on the mounting debt can no longer be met from taxation, forcing reliance on the printing press, the government's credit would be seriously threatened. But when all is said and done, it seems that the answer to the question of inflation rests not only on economic considerations but also on psychological factors. The inability to realize our own limitations, financial and otherwise, coupled with blind, selfish pressure-group activities, might produce consequences of the most terrifying dimensions. History shows that once economic laws have been grossly flouted, only the character and intelligence of the people and their leaders, plus the Law of Accident, can act to save them.