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WHAT IS INFLATION?
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Q: What is inflation?
A: Inflation is the process whereby things - balloons, tyres, opinions, *etc.* - become enlarged. In economics inflation refers to money. Money is inflated when more goes into circulation. However, the usual inference is that *too much* goes into circulation.

Q: 'Too much' in what sense?
A: When monetary expansion is excessive, the implication is that individuals are holding too much money.

Q: 'Too much' in what sense?
A: Too much money! You cannot have too much money.
A: I'm guessing you mean that you'd waste no time in spending money, if you had more of it.

Q: Absolutely. I'd go right out and spend it.
A: Then, in that situation, you'd be described as having (albeit temporarily) an excess of money holdings; and, in spending it there would be additional demand for goods and services

Q: So where's the inflation?
A: Lets go back a bit and ask ourselves how new money enters into circulation

Q: How does that happen?
A: The authorities who create new money have first use of it. So, the temptation to create new money is ever-present.

Q: I don't follow you.
A: Currency notes are produced very cheaply. Suppose it costs only ten pence to print a £20 currency note and that *you* had the power to print currency notes. What would be the consequence?

Q: Great happiness! I could buy anything that I wished.
A: Yes. You could exert enormous extra demand upon the economy, without having to supply anything into it (apart from money). Greatly enhanced demand, with nothing extra supplied means ....

Q: .... higher prices.
A: Exactly!

Q: So, counterfeit currency causes inflation?
A: It is a minor cause. The unauthorised printing of currency notes is not significant.

Q: Who, then, is primarily responsible?
A: The government is responsible for inflating the amount of money in circulation.

Q: Why does it do it? What is the motive? Inflation is disliked. Why should the government make itself unpopular?
A: A government attracts unpopularity in many ways, most obviously when it raises revenue. Either it imposes taxes, or it borrows (which raises interest rates), or it prints new currency. All are unpopular. Inflation may be the least unpopular.

Q: Governments often blame trade unions for causing inflation.
A: Trade unions are common scapegoats, but inflation has also been blamed on the rising cost of raw materials and energy.

Q: Don't they have a point?
A: Were the cost of labour, raw materials and energy to rise continuously, this would more likely be a symptom than a cause.

Q: The cause being an excessive increase of money in circulation?
A: Yes.

Q: Surely trade unions can act independently of monetary pressures.
A: Of course they can but, if union action pushes up the cost of labour-intensive commodities, this can result in unemployment, but it cannot be the cause of inflation.

Q: If unions negotiate excessive wage increases, firms may become unprofitable and cease trading?
A: Of course.

Q: But for firms that remain in business, costs are higher?
A: Probably.

Q: And those firms increase their prices?
A: Probably.

Q: So higher wage costs cause inflation!
A: The higher level of wages causes an increase in the level of prices.

Q: That's inflation!
A: No it's not. Inflation is a process: a continuing tendency. A one-off increase in wage costs (or raw material costs or energy costs) is fully accommodated by a single price increase.

Q: That sound like inflation.

A: But it isn't. You could ask for £100,000 a day. If you can't find work at that rate, your demand is irrelevant to inflation. If you do find work, it is because someone values your services at that rate; and good luck to you.

Q: Union members lucky enough to keep their jobs receive higher wages?
A: Yes, and if this continues - if there *were* a process of continuously rising wage demands - every union member would eventually be priced out of work. Competition would ensure that.

Q: What if every worker belongs to a trade union and every wage is raised by the same amount, so that every producer is affected?
A: Then I suppose that every price would be raised in strict proportion.

Q: That's my point.
A: Even in this strange world of supposition, this is not inflation; not monetary inflation anyway. Money would be irrelevant in this world of your supposition.

Q: I don't understand.
A: Money fills gaps between transactions. If you sell something before you know what it is that you wish to buy, money fills the gap.

Q: So what?
A: The uniformity of increased wages and prices (in your strange world of supposition) implies no need of money.

Q: Why?
A: Because employers must be buying labour hours at precisely the same instant as they are selling the items produced in those hours. And wages must be instantaneously spent on goods, immediately as they are produced.

Q: Why?
A: How else could you explain uniform increases in all wages and prices simultaneously?

Q: You have twisted my words.
A: I have pointed to the implication of your words. In your world, what use is money?

Q: To set prices.
A: If unions can raise wages without causing unemployment, prices have no function. By your supposition, price relativities and trading patterns are unchanged by union activity. An apple may cost 20 pence or £20; but that price is irrelevant. All money prices are irrelevant. Money is irrelevant.

Q: This is *very* theoretical. What is the evidence?
A: The most powerful historical evidence for the irrelevance of trade union activity is that inflation occurs regardless of the presence of (or absence of) or strength of trade unions.

Q: And with respect to the money supply? What is the evidence on that?

A: Let me give you a very specific illustration. In 1928, a new Irish currency was created and, for over fifty years, the unit of this new currency - the ‘punt’ - was maintained equal in value to sterling.

Q: How was that achieved?
A: It was achieved by banking arrangements whereby monetary policy in Eire was determined by decisions in London.

Q: So, for practical purposes, the ‘punt’ might as well not have been introduced?
A: That’s right. Since monetary policy was identical in both London and Dublin, inflation rates were identical in both countries.

Q: How long did this go on?
A: These arrangements continued until the link with sterling was severed in 1979.

Q: .... and then the inflation rates diverged?
A: That’s right.

Q: What should we conclude from this?
A: Two things: (1) that inflation is entirely dependent upon monetary policy; and (2) if there is a fixed exchange rate with another currency, the monetary policies which are administered in respect of those currencies must be inter-dependent.

Q: Wouldn’t that mean that if several nations entered into a monetary union, each would surrender its ability to conduct an independent monetary policy?
A: Exactly; but let’s return to inflation itself.

Q: Good idea. Let me see ... what happens if inflation is allowed to continue unchecked?
A: Ultimately, the currency becomes worthless. This is referred to as hyper-inflation, and it typically occurs in three stages.

Q: Go on.
A: The first stage is often associated with the huge costs of waging war. If the general public believes that these extra expenditures are a temporary phenomenon ...

Q: One would hope so.
A: ... then they must also believe that the war-time inflation of prices is also temporary.

Q: And is it?
A: That depends on the subsequent action of the authorities and the re-action of the general public.

Q: I don’t follow.
A: Is the willingness of individuals to accept money likely to remain unchanged? If they believe that the purchasing power of money is eventually likely to stabilise, then inflation is more likely to be brought under control.

Q: Because there is no ‘flight’ from the currency?

A: That's right. And through this willingness, the rate of inflation might be much less than the rate of monetary growth.

Q: So what happens then?
A: Monetary expansion is an easy option when funds are short. So, the authorities might be tempted to continue to inflate their currency even after hostilities cease. Then, as inflation continues, the expectations of the general public would be likely to change.

Q: Expectations that prices will stabilise are disappointed?
A: If the fall in the purchasing power of money gains pace, individuals would become increasingly nervous about holding on to money. Money would circulate faster and prices would rise at an ever-faster rate. The second stage begins.

Q: Has this actually happened?
A: Yes, it happened during the German inflation of 1921-23. With the Great War, the money supply rose by 340 per cent; but prices increased by only 139 per cent. From November 1918 to July 1919, money increased by a further 57 per cent and prices still rose to a lesser degree.

Q: This is stage one?
A: Yes; but in the following six months, prices began to gain ground, rising by 185 per cent, compared with a 33 per cent increase in money.

Q: In phase one, money grows faster than prices; in phase two, prises rise faster than money?
A: That's right. In Germany, phase two ran from May 1921 to July 1922. Money rose by 149 per cent and prices by 635 per cent.

Q: What happened?
A: Paradoxically, with prices rising so rapidly there was a shortage of money!

Q: What?
A: Prices were so high that there was *too little* money to go round. It became necessary to match income receipts much more closely with expenditure. This was beneficial in another way. It reduced the loss from holding on to a rapidly depreciating currency.

Q: How did they match income receipts more closely with expenditure?
A: Let me give you one illustration: in Germany, workers were allowed time off work at ever shorter intervals in order to spend their (rapidly depreciating) earnings.

Q: Hardly conducive to industrial productivity!
A: Just one of example of the damage caused by inflation.

Q: What is its third stage?
A: The third and final stage of inflation comes when the currency collapses and individuals are ready to accept just about anything in payment in preference to money.

Q: Money is worthless?
A: Virtually ... about as valuable as used stamps!

Q: Some used stamps are valuable.
A: Not when billions of them are readily available to collectors

Q: Can we stop there?
A: Perhaps we should!