The Errors and Dangers of the Price Stability Policy |

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Confused Central Bankers

There is one refrain that is always heard when central bankers hold speeches, give interviews or issue press releases. They all maintain that their policies aim to ensure 'stability'. In the course of a typical ECB press conference one will usually hear ECB president Jean-Claude Trichet utter the word 'stability' several times. The most recent example can be found in an article in the WSJ, entitled 'Price Stability Vital'.

> *„The European Central Bank must avoid at all costs the rise in oil and commodities prices being passed on to wages and other prices, its president, Jean-Claude Trichet, said Sunday, repeating that the ECB will do whatever it takes to ensure price stability in the euro zone."*
>
> *[…]*
>
> *„"There is nothing we can do against the rise in oil and commodity prices, but we must avoid at all costs second-round effects," including on salaries, Mr. Trichet said in an interview on French radio Europe 1. Second round effects materialize when the rise in raw material prices is passed on to the cost of other goods and services as well as on to wages, fueling an increase in inflation.*
>
> *Repeating that the balance of risks is tilted to the upside on inflation in the short term because of higher food and oil prices, Mr. Trichet said the ECB will do whatever is necessary to maintain price stability."*
>
> *[…]*
>
> *„He also said inflation expectations were well anchored, a key factor for central banks in their fight against inflation. "Everyone expects us to deliver inflation that is in line with our objective in the next 10 years," he said."*

(our emphasis)

You will notice that another point we highlighted above aside from the repeated pledge to 'ensure price stability' is Trichet's point about 'inflation expectations', which are held to be a 'key factor for central banks in their fight against inflation' (although central banks are the engines of inflation, they like to portray themselves as 'inflation fighters' – it is rather Orwellian).

As we will attempt to show, this is just as misguided a notion as the idea that the policy of 'price stability' represents a worthwhile goal. Before we continue, note that Federal Reserve chairman Ben Bernanke frequently mentions these arguments as well. A case in point is this recent report from the AFP about Bernanke's latest appearance before Congress. Both 'price stability' and 'inflation expectations' rated a mention.

> *“We remain unwaveringly committed to price stability," Bernanke told the House of Representatives budget committee, rejecting claims that rising prices for food and oil heralded dangerously speeding inflation.”*
>
> *[…]*
>
> *“Bernanke admitted that prices had risen for gasoline and other products, but he said overall inflation remained low and unemployment was still unacceptably high.*
>
> *"We have recently seen increases in some highly visible prices," Bernanke said.*
>
> *But he cited growth in economies like China, India and Brazil as the real cause of price rises.*
>
> *"The inflation is taking place in emerging markets because that's where the growth is."*
>
> *In the US, he added, "overall inflation is still quite low and longer-term inflation expectations have remained stable."*

(our emphasis)

Here you will notice that we have emphasized yet another concept championed by Bernanke – namely, the idea that 'inflation' is somehow an effect or outcome of 'economic growth'. He could not possibly be more wrong.

Erroneous Assumptions

You may well ask at this point, but what is wrong with all that? Why shouldn't the central banks pursue a 'stability policy' and do what is required to 'keep inflation expectations in check'? Isn't stability a good thing? After all, economic calculation requires money prices, and would not such calculation be easier to accomplish if money prices were stable?

One problem with all this is that there exists no objective yardstick by which this so-called 'stability' could be established. The measurements used in the attempt to create such yardsticks try to measure what is ultimately unmeasurable.

On this Mises wrote:

> *“It is easy to understand why those whose short-run interests are hurt by a change in prices resent such changes, emphasize, that the previous prices were not only fairer but also more normal, and maintain that price stability is in conformity with the laws of nature and of morality. But every change in prices furthers the short-run interests of other people. Those favored will certainly not be prompted by the urge to stress the fairness and normalcy of price rigidity.*
>
> *Neither atavistic reminiscences nor the state of selfish group interests can explain the popularity of the idea of price stability. Its roots are to be seen in the fact that notions concerning social relations have been constructed according to the pattern of the natural sciences.*
>
> *The economists and sociologists who aimed at shaping the social sciences according to the pattern of physics or physiology only indulged in a way of thinking which popular fallacies had*

> *adopted long before.*
>
> *Even the classical economists were slow to free themselves from this error. With them value was something objective, ix., a phenomenon of the external world and a quality inherent in things and therefore measurable. They utterly failed to comprehend the purely human and voluntaristic character of value judgments."*
>
> *[…] and further:*
>
> *"It is not only a task of economic science to discard the errors concerning measurability in the field of action. It is no less a task of economic policy. For the failures of present-day economic policies are to some extent due to the lamentable confusion brought about by the idea that there is something fixed and therefore measurable in interhuman relations."*

(our emphasis)

From Human Action, chapter XII, 4, 'The Changeability of Prices'

As you can see from the above, the central problem according to Mises is the fact that all value judgments are subjective. In turn, the ordering of such value judgments (the order of preferences) occurs at a definite moment in time, marked by definite circumstances, and is not computable. If someone pays $500 for an I-Pad, then he values the I-pad more highly than the $500 at the point in time when the purchase occurs. In turn, the seller of the I-pad, at that same moment, values the $500 more highly than the I-Pad. That is all that can be asserted about this transaction. If indeed such a transaction has occurred, then it becomes a datum of economic history. It could be that a few days later, an identical I-Pad is exchanged for $480. Evidently, the seller would have preferred if a 'policy of price stability' had allowed him to sell the I-Pad at old price of $500, while the buyer would be quite happy to have paid less. And yet, at the moment the transaction occurred, the buyer preferred owning an I-Pad over holding on to his $480, while the seller preferred the $480 over hanging on the the I-Pad. Nothing about this allows one to draw any inferences about the desirability of a price stability policy.

As Mises points out, it is a central failing of modern-day economists to assert that economic data can be used in the manner the natural sciences use measurable and objective data about nature. The social sciences and the natural sciences are different fields of inquiry, and they require different methods of analysis. Human action is not quantifiable.

Attempts to Measure the Unmeasurable

Mises then notes that it is precisely this error in thinking that has made the stabilization policy popular.

> *"An outgrowth of all these errors is the idea of stabilization. Shortcomings in the governments' handling of monetary matters and the disastrous consequences of policies aimed at lowering the rate of interest and at encouraging business activities through credit expansion gave birth to the ideas which finally generated the slogan "stabilization." One can explain its emergence and its popular appeal, one can understand it as the fruit of the last hundred and fifty years' history of currency and banking, one can, as it were, plead extenuating circumstances for the error involved. But no such sympathetic appreciation can render its fallacies any more tenable.*
>
> *Stability, the establishment of which the program of stabilization aims at, is an empty and contradictory notion. The urge toward action, i.e., improvement of the conditions of life, is inborn in man.*
>
> *Man himself changes from moment to moment and his valuations, volitions, and acts change with him. In the realm of action there is nothing perpetual but change. There is no fixed point*

> *in this ceaseless fluctuation other than the eternal aprioristic categories of action.*
>
> *It is vain to sever valuation and action from man's unsteadiness and the changeability of his conduct and to argue as if there were in the universe eternal values independent of human value judgments and suitable to serve as a yardstick for the appraisal of real action."*

Human Action, ch. XII, 5, 'Stabilization'

He further notes that all attempts to measure the changes in the purchasing power of money with the help of 'price indexes' is doomed to failure , since the ever-changing and evolving economy and the ever changing and evolving preferences of individual actors in the economy preclude such measurements. Since there is no objective standard to which such measurements could be anchored, there is nothing to measure.

Says Mises:

> *"All methods suggested for a measurement of the changes in the monetary unit's purchasing power are more or less unwittingly founded on the illusory image of an eternal and immutable being who determines by the application of an immutable standard the quantity of satisfaction which a unit of money conveys to him. It is a poor justification of this ill-thought idea that what is wanted is merely to measure changes in the purchasing power of money. The crux of the stability notion lies precisely in this concept of purchasing power. The layman, laboring under the ideas of physics, once considered money as a yardstick of prices. He believed that fluctuations of exchange ratios occur only in the relations between the various commodities and services and not also in the relation between money and the "totality" of goods and services. Later, people reversed the argument. It was no longer money to which constancy of value was attributed, but the "totality" of things vendible and purchasable.*
>
> *People began to devise methods for working up complexes of commodity units to be contrasted to the monetary unit. Eagerness to find indexes for the measurement of purchasing power silenced all scruples. Both the doubtfulness and the incomparability of the price records employed and the arbitrary character of the procedures used for the computation of averages were disregarded.*
>
> *Irving Fisher, the eminent economist, who was the champion of the American stabilization movement, contrasts with the dollar a basket containing all the goods the housewife buys on the market for the current provision of her household. In the proportion in which the amount of money required for the purchase of the content of this basket changes, the purchasing power of the dollar has changed. The goal assigned to the policy of stabilization is the preservation of the immutability of this money expenditure. This would be all right if the housewife and her imaginary basket were constant elements, if the basket were always to contain the same goods and the same quantity of each and if the role which this assortment of goods plays in the family's life were not to change. But we are living in a world in which none of these conditions is realized."*

ibid.

The debates that are raging nowadays over the 'correct measures of inflation', i.e. the methodologies used to construct various price indexes (see e.g. the critique of shadowstats.com regarding the currently used formulas and how they compare to those used in the past) , completely ignore the fundamental problem. The government's statistics have changed over time and are now attempting to incorporate factors such as changes in product quality and shifts in household consumption habits. However, by necessity the rigid formulas used in these calculations must be based on arbitrary assumptions (take for instance the issue of 'lowering the weightings' of goods that have increased in price in the basket of goods and services measured). They are not really *measuring* anything – they amount to a guessing game. It is not possible to measure the 'change in the average price of all goods'. Consider the following objection by Mises:

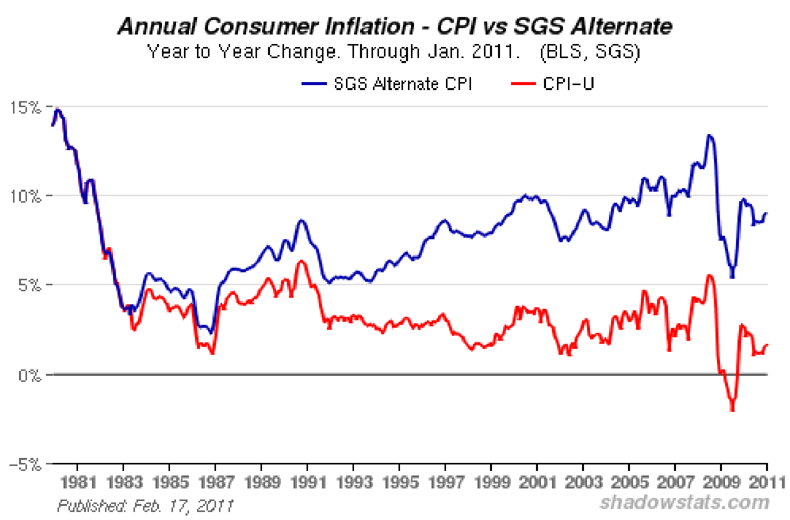
> *"It is a mistake to identify wheat with wheat, not to speak of shoes, hats, and other manufactures. The great price differences in the synchronous sales of commodities which mundane speech and statistics arrange in the same class clearly evidence this truism. An idiomatic expression asserts that two peas are alike; but buyers and sellers distinguish various qualities and grades of peas. A comparison of prices paid at different places or at different dates for commodities which technology or statistics call by the same name, is useless if it is not certain that their qualities – but for the place difference – are perfectly the same. Quality means in this connection: all those properties to which the buyers and would-be-buyers pay heed."*

ibid.

The government nowadays employs so-called 'hedonic indexing' to reflect quality improvements of certain goods , but consider Mises' example of a simple product like peas. For all we know there may at any given time be 10 or 20, or more different qualities of peas. Changing tastes regarding their consistency and color may influence price changes of different qualities over time. It is impossible to accurately capture such changes for the totality of goods and services. One could also say, there are prices for goods and services – but there is no 'general price level'. There is therefore nothing that can be stabilized.

To be sure, the criticisms leveled by e.g. 'www.shadowstats.com' at the government's methodologies are justified in one sense. At the root of this particular debate is the fact that government has changed its statistical method of calculating price indexes in such a way as to make the effects of inflation appear as minuscule as possible. Officially, the aim was to provide a 'more correct' methodology. Unofficially, the aim is to make government's conduct of monetary policy appear in a better light than it deserves and to lower those government expenses (such as pensions) that are subject to 'indexation'. Government has proved remarkably successful in achieving these ends.

We may also concede that price indexes such as they are calculated by shadowstats (which uses the 'old' government methodologies, prior to the reform of these methods under the Boskin commission) as well as those published by the department of commerce , do convey some information about the general trend of the loss of purchasing power. But it makes little sense to assert things like 'consumer prices have risen by 0.3% last month'.



The 'official' CPI compared to the 'alternate CPI' published by John Williams' shadowstats – click for higher resolution.

Enter Tony Soprano

Another important point is that economic growth does not result, as Bernanke maintains, in 'inflation', or rather, in rising prices (we define inflation as an increase in the money supply, something that clearly is in the central bank's purview and not caused by exogenous factors; for reasons of obfuscation the semantic trick of confusing the cause – namely the inflation of the money supply, with its effect – namely rising prices, has become widely used. In this manner the cause is relegated to the memory hole, so to speak).

'Growth' implies that more goods and services are produced. An increase in the production of goods must , *ceteris paribus*, lead to lower prices over time (as a general remark, when elucidating certain concepts, it is often necessary to resort to such abstraction, i.e. to posit '*ceteris paribus*' conditions that are not attainable in real life. This should not detract from the usefulness of such abstractions in helping to explain the conditions of reality).

A problem only arises when the money supply is increased by the creation of new banknotes and additional fiduciary media (deposit money) from thin air.

If we consider economic activity and what funds it, it should be clear that money is not funding anything as such. All economic activities are funded by unconsumed final goods. Consider the hypothetical case of embarking on a long range investment project that requires ten workers to be realized. In the time that passes between its initiation and the point when the contribution of this long range project to the production of consumer goods reaches fruition, the lives of these workers must be sustained. In short, present (i.e. consumer) goods must be made available to them for consumption. Obviously, if the pool of such saved present goods is not sufficiently large to achieve this, then it matters little how much money someone at the central bank prints. The project will never come to fruition. More generally we can state, the size of the pool of real funding and the scarcity of capital set the limits of what is possible in terms of economic activities (it should be noted that goods of the lowest order, i.e., consumption goods, become from the point of view of the entrepreneur/capitalist, higher order goods when they are employed in production processes).

Let us now say that an economic actor in a free market economy by the name of Fritz wishes to exercise a demand for money. To do so, he must first sell his own previously produced products or services in the marketplace. In this type of transaction, Fritz contributes to the pool of goods and services, while receiving money with which he can subsequently exercise a claim on whatever other goods and service he wants to acquire from the pool.

Consider now the case of Tony Soprano, who has in his cellar a machine with which to counterfeit money. He can use this money to divert real goods to himself, but he won't contribute anything to the pool of funding in return. Total spending in the economy would increase, but there would be no increase in wealth. On the contrary, those producing wealth, such as Fritz, would find that when they want to exercise their claims on goods, fewer goods are available to them than there would be if Tony had not introduced counterfeit money (what Tony has diverted to himself and consumed has literally gone missing, since he has not contributed anything in its place).

To the extent that Tony's banknotes are well made counterfeits that remain undiscovered, his actions are in principle no different from those of a central bank creating money from thin air or a commercial bank creating fractionally reserved deposits from thin air. The only difference would be that Tony's money would likely enter the economy at different points.

Let us once again consider Fritz and other honest actors in the market economy. To the extent that their income exceeds their spending, they are engaging in saving. The size of their savings is the amount of consumption they have deferred. In essence they are refraining from present consumption so that they may consume more in the future. If the interest rate their savings can obtain in the loanable funds market is 5% p.a., then they prefer an increase of 5% in their potential consumption one year hence to consuming this saved income in the present. Put in another way, they have expressed their time preference. The natural, or originary interest rate is a price ratio of the value of present goods vs. that of future goods. If, on a society-wide basis, more income is allocated to saving, the natural interest rate will tend to decline – as the amount of future consumption that is preferred to present consumption has increased. Although the savings are kept in the form of the medium of exchange, a concomitant increase in the pool of real funding has occurred as well (since goods available for consumption have remained unconsumed). Therefore, the interest rate is a signal that conveys important information to entrepreneurs: it tells them whether the pool of savings has increased or decreased, which at the same time informs them also about the future demand schedules of consumers. Thus it helps with aligning production schedules and consumer demand schedules.

In order to increase wealth, economic productivity must be increased. What increases productivity in turn is the addition of new stages of production to the existing productive structure. The more 'roundabout', or longer, production processes that result from such additions, will ultimately bring about a larger output of goods and services. They may also enable the production of goods that did not exist before. Since the addition of new stages of production means that more time will pass before the higher output of final goods emerges, it is obviously important that these processes be coordinated with the consumption schedules of consumers. A change in interest rates exerts an effect on *relative* prices within the capital structure, as the interest rate serves as a tool to calculate, or discount, the value of capital goods over time. A lower interest rate makes higher order goods that are more distant in time from the final goods they help to produce *relatively* more valuable, hence factors of production will be bid away by entrepreneurs engaged in the higher order branches of production from the lower order goods production stages. The production structure as a whole will shift toward a more productive and longer mode of production and allocate more resources to the production of capital goods relative to the the production of consumer goods.

Moreover, in order to make it even possible to *realize* these longer term investment projects, a sufficiently large pool of savings must be available for the purpose of investing in them – otherwise they will be doomed to fail.

This is best illustrated with the anecdote of the master builder. As recounted by Mises:

> *"The whole entrepreneurial class is, as it were, in the position of a master-builder whose task it is to erect a building out of a limited supply of building materials. If this man overestimates the quantity of the available supply, he drafts a plan for the execution of which the means at his disposal are not sufficient. He oversizes the groundwork and the foundations and only discovers later in the progress of the construction that he lacks the material needed for the completion of the structure."*

From L.v. Mises, Human Action, ch. XX., 6

It is obvious from this that a falsification of market data – such as results from expansion of the money supply and the consequent suppression of the interest rate from its natural level – will lead to what Austrians term 'malinvestment'. This is to say, entrepreneurs will erroneously start investment projects that are deemed viable due to the low interest rate, but can not in reality be realized, as the size of the pool of savings is not sufficient for doing so. The appearance of additional banknotes and fiduciary media creates the illusion that consumer time preferences have changed and that they have allocated more of their incomes to saving as opposed to consumption. In reality though, no such shift has occurred.

Tony Soprano, by introducing counterfeit money, has effected exchanges of 'nothing' (his fake bank notes) for 'something' (the real goods and services he lays claim to). The more such exchanges occur, the more the pool of real funding will tend to weaken. The rise in prices that becomes evident once the new money has percolated through the economy is only a *symptom* of the destruction of wealth that the increase of the money supply has brought about.

In other words, the proponents of the 'stabilization policy' are putting the cart before the horse. They argue that it is the 'rise in the general price level' that is apt to do economic damage. In reality, the rise in the general level of prices (used in the abstract sense here, since the problem of its unmeasurability can not be wished away) is symptomatic of the economic damage that the increase in the supply of money, i.e., inflation, has *already* wrought.

The Long Range Effects and Dangers of the Stabilization Policy

Given that central banks have engaged in the 'stabilization policy' for a long time, one may well ask: Why then has the economy become so unstable? Why is it plagued by massive boom-bust cycles?

If it is true, as central bankers claim, that hewing to a monetary policy that ensures that government's price index measures don't deviate from a specific annualized target rate of change will deliver economic progress and stability, then how come that in reality, we have just experienced one of the biggest financial and economic crashes in modern history?

The preceding paragraph already provides a summary of the theoretical background to answering this question, but there are several more points to consider.

In a free market economy, the most marketable good will tend to emerge as money. This is to say, a good for which there is already a preexisting demand and that best fulfills the criteria making it useful as money, will be chosen – by a process of trial and error – to serve as the money commodity. High marketability, a sufficiently large, but only slowly growing stock, scarcity, fungibility, durability, portability and divisibility are all attributes that are likely to characterize a commodity useful as money. Historically, the commodities chosen by the market as most useful to serve as money have been gold and silver. One of the characteristics of the money commodity will be that the *monetary* demand for it will dwarf the non-monetary demand, a feature that continues to be observable in the case of gold, in spite of the fact that it is at present not used as a general medium of exchange. We could state that in spite of the 'demonetization' of gold by government fiat, the market continues to view and treat gold as though it were money.

One major reason why gold is suitable to render the services of a medium of exchange is that its supply can not be increased at will. The detrimental effects that monetary inflation exerts on the economy would be absent if gold were still used as money. However, it must be noted that even if gold were once again used as money, it would still be possible for fractionally reserved banks to set in motion boom-bust cycles by increasing the amount of fiduciary media or by issuing more receipts for gold (i.e., bank notes) than are actually backed by gold stored in their vaults. Alas, they could no longer avoid the deflationary contractions that would mark bust phases absent a lender of last resort that can print up new money at will from thin air. A run on the banks would have the salutary effect of actually putting the most egregious abusers and worst stewards of capital out of business, contrary to what has happened in the most recent bust. We have previously argued that in a non-cartelized system of free banking, fractional reserves banking would likely disappear over time, as consumers would prefer using fully reserved banks for the purpose of warehousing their gold. Nonetheless, the temptation to engage in the practice would remain high, due to the additional profits banks can arrogate to themselves by means of inflationary credit expansion.

The introduction of a full-fledged fiat money system has been defended by the argument that such a system of 'flexible currency' under the direction of a central bank will allow a certain degree of central economic planning that is deemed necessary to alleviate the alleged 'failures of the free market'. To the extent that economists take this argument seriously, they have not understood or are unaware of the calculation problem that besets central planners (J.H. De Soto argues convincingly that the concept of the socialist calculation problem first identified by L.v. Mises as a result of the absence of a price system for capital goods and factors of production in a communist economy can be extended to the sphere of central economic planning a central bank engages in).

In reality, the central bank directed fiat money system enables the government to spend far more money than it takes in in the form of tax revenue, while at the same time enabling the banking system to make profits it could not possibly make if sound money were in use and sound banking practices based on traditional legal principles were the norm. The giant modern-day welfare/warfare state critically and manifestly depends on *unsound* money.

The 'stability policy' in turn is designed to ensure the continuation of this system for as long as is possible.

Let us however be generous and assume that many of the defenders of this facet of central economic planning are motivated by honorable motives and simply wish to increase social welfare. To this we would say that regardless of their motives, they will still fail in the endeavor due to the fact that their theories are not tenable. Simply put, central economic planning can not work, regardless of whether the motives and intentions of its proponents are honorable.

The enormous dangers of the stability policy and its misguided precepts can be illuminated not only by economic theory, but also by understanding events of economic history.

One important question that suggests itself is the following: what if there is enough real wealth creation that inflation – i.e., an increase in the supply of money – does *not* result in a palpable increase in the so-called 'general level of prices' (once again, we use this term merely conceptually). In short, what if the increase in the production of goods and services, due to sensible past investment decisions, is large enough that an increase in the money supply doesn't result in notable price increases for consumer goods? In this case, the proponents of the stability policy would no doubt claim that the policy is a success.

Nothing could be further from the truth. As Murray Rothbard noted in 'America's Great Depression', chapter 6:

> *“One of the reasons that most economists of the 1920s did not recognize the existence of an inflationary problem was the widespread adoption of a stable price level as the goal and criterion for monetary policy. The extent to which the Federal Reserve authorities were guided by a desire to keep the price level stable has been a matter of considerable controversy. Far less controversial is the fact that more and more economists came to consider a stable price level as the major goal of monetary policy. The fact that general prices were more or less stable during the 1920s told most economists that there was no inflationary threat, and therefore the events of the great depression caught them completely unaware.*
>
> *Actually, bank credit expansion creates its mischievous effects by distorting price relations and by raising and altering prices compared to what they would have been without the expansion. Statistically, therefore, we can only identify the increase in money supply, a simple fact. We cannot prove inflation by pointing to price increases. We can only approximate explanations of complex price movements by engaging in a comprehensive economic history of an era—a task which is beyond the scope of this study. Suffice it to say here that the stability of wholesale prices in the 1920s was the result of monetary inflation offset by increased productivity, which lowered costs of production and increased the supply of goods. But this “offset” was only statistical; it did not eliminate the boom–bust cycle, it only obscured it. The economists who emphasized the importance of a stable price level were thus especially deceived, for they should have concentrated on what was happening to the supply of money.”*

(our emphasis)

The boom of the 1920's was a prime example of how during times of strongly rising economic productivity, the 'price stability' policy allows for enormous expansion of the money supply to occur, while the prices of consumer goods concurrently remain fairly stable. This in turn tends to obviate any concerns or reservations the monetary authority and most economists may harbor on account of the boom. In reality, by confusing inflation with one of its possible effects, the 'stabilizers' allow a period of vast credit expansion and the malinvestments it engenders to run completely unchecked. This was certainly the case in the boom of the 1990's and to a lesser extent in the 2002-2007 period as well. Similar to Rothbard's observation about the 1920's boom, we note that especially the 1990's boom was marked by strong increases in economic productivity, which helped mask the effects of a massive credit and money supply expansion. The strong rise in productivity *should* have produced an economy-wide decline in prices of most goods and services – which is precisely what *would* occur in a free market economy using a market chosen money. That prices have not fallen in this time period is an effect of the money supply expansion.

The computer industry itself, which played a significant role in helping to raise productivity across many branches of production is testament to what happens when productivity is rising very strongly. In the case of this industry, the speed at which its productivity increases was and is so fast that not even massive monetary inflation can keep its prices 'stable'. Instead, prices have fallen every single year since this industry was born and by all indications continue to do so. Obviously, this has not been to the detriment of the industry, which remains to this day one of the most vibrant in the economy and clearly contributes greatly to wealth creation. This exposes the Bernankean view (shared by most mainstream economists) that falling prices must be labeled a 'bad thing' as a fallacy.

While we can also not engage in a thorough study of economic history here, it is still possible to employ some degree of historical understanding in explaining the root causes of the inflationary booms of both the 1920's and 1990's, i.e. what it was that allowed a certain degree of real wealth creation to mask the effects of the inflationary policies of both eras. In both instances, the boom was preceded by a brief, but intense economic crisis during which the central bank, contrary to its usual *modus operandi* felt compelled to keep its policy fairly tight – because increases in the 'general price level' were in both cases highly visible and had in the view of the central bank evolved into a systemic threat. In the 1920/21 inflationary recession, brought on by the post WW1 inflationary boom, the Federal Reserve refused to lower rates until prices had fallen a great deal. Similarly, the Volcker-led Fed of the early 1980's imposed a high interest rate policy to break the back of a seemingly out-of-control inflation episode. We would argue that in both instances , high real interest rates helped with the liquidation of a great many unsound investments and loans, while concurrently providing an incentive for an increase in saving. The severe, but short, recessions in both instances laid the groundwork for an era of real wealth creation, which was then given an additional shot in the arm by the adoption of an array of new technologies in production processes and the associated lengthening and deepening of the capital structure. Unfortunately, the decline in prices this should have produced was arrested by the 'stabilization' policy. Note here that both during the 1920's and 1990's boom, a stock market bubble was providing evidence that something was amiss. As Rothbard notes, the stock market is where titles to capital goods are traded, so an unusual boom in stock prices is a strong piece of circumstantial evidence pointing to the fact that an inflationary – and ultimately unsustainable and unhealthy – boom is underway.

> *"The trouble did not lie with particular credit on particular markets (such as stock or real estate); the boom in the stock and real estate markets reflected Mises's trade cycle: a disproportionate boom in the prices of titles to capital goods, caused by the increase in money supply attendant upon bank credit expansion."*

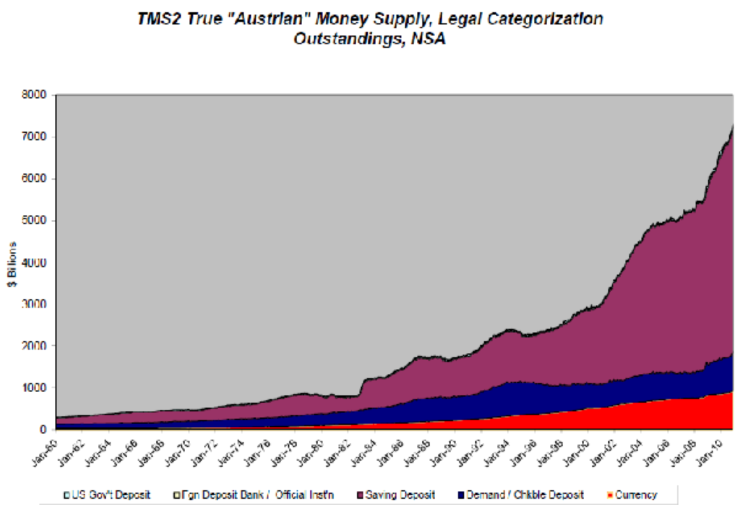
Murray Rothbard, America's Great Depression, ch. 6

The cohabitation of real wealth generation and inflation-induced malinvestment typical of this type of boom allows the inflationary boom to go on much longer than would otherwise be the case – it will therefore be able to do a great deal of damage. This also partly explains why the capital consumption that finances the non-wealth generating activities of the boom, i.e. the economic activities that can only exist on account of the credit expansion and the artificial lowering of the interest rate, can go on for so long before it overwhelms the economy's capacity to sustain the boom.

As Mises notes to this and the previously made points:

> *“A sharp rise in commodity prices is not always an attending phenomenon of the boom. The increase of the quantity of fiduciary media certainly always has the potential effect of making prices rise. But it may happen that at the same time forces operating in the opposite direction are strong enough to keep the rise in prices within narrow limits or even to remove it entirely. The historical period in which the smooth working of the market economy was again and again interrupted through expansionist ventures was an epoch of continuous economic progress. The steady advance in the accumulation of new capital made technological improvement possible. Output per unit of input was increased and business filled the markets with increasing quantities of cheap goods. If the synchronous increase in the supply of money (in the broader sense) had been less plentiful than it really was, a tendency toward a drop in the prices of all commodities would have taken effect. As an actual historical event credit expansion was always embedded in an environment in which powerful factors were counteracting its tendency to raise prices. As a rule the resultant of the clash of opposite forces was a preponderance of those producing a rise in prices. But there were some exceptional instances too in which the upward movement of prices was only slight. The most remarkable example was provided by the American boom of 1926-29.*
>
> *The essential features of a credit expansion are not affected by such a particular constellation of the market data. What induces an entrepreneur to embark upon definite projects is neither high prices nor low prices as such, but a discrepancy between the costs of production, inclusive of interest on the capital required, and the anticipated prices of the products. A lowering of the gross market rate of interest as brought about by credit expansion always has the effect of making some projects appear profitable which did not appear so before.”*

L.v. Mises, Human Action, ch. XX., 6



A chart of US broad true money supply TMS-2 (via Michael Pollaro; this money supply definition follows the Rothbard-Salerno model). Clearly, the one datum that we *can* observe objectively, because it is a simple manner of adding up the components of the money supply – to paraphrase Rothbard, the 'simple fact we can identify' – namely the increase in the supply of money, shows us that the booms of the 1990's and the 2002-2007 period were unhealthy inflationary booms, in spite of central bankers and government statisticians' claims that there was 'no (or very little) inflation' – click for higher resolution.

We can conclude that the stabilization policy is especially dangerous when it stops prices from *falling* during boom periods. The so-called 'Great Moderation' – a term Ben Bernanke employed to describe the easy money booms of the post Volcker era – was not a mark of the 'success' of this policy. It merely masked the enormous damage that the economy suffered on account of the credit and money supply expansion. In spite of Bernanke's protestations to the contrary (he blames 'weak regulations' as the cause of the massive economic crisis that has followed in the wake of the boom's last iteration), this should be quite clear in view of what has since happened.

It should also be clear that the easy money policies of the present day – which central bankers once again defend on the grounds that they have allegedly 'not created any inflation' - are liable to do similar or even greater damage.

Ironically, the Bank of England can these days not even point to tame 'price indexes' anymore to defend its easy money policy. Instead, Mervyn King and his colleagues are forced to resort to a long litany of excuses and promises, since the government's very own statistics refuse to confirm that 'stability' is still the order of the day.

What About Inflation Expectations?

Finally we want to briefly touch on the topic of 'inflation expectations', which is accorded such a prominent place in the views held by today's central bankers. The argument essentially seems to go that 'as long as we can convince the public that our policy is not inflationary, prices will not rise'. A corollary to this would then be the assumption that it is 'expectations' that 'create inflation' (in the sense of, a rise in all or most consumer prices).

Most people tend to view the purchasing power of money as fairly stable over shorter to medium term time periods. When thinking about tomorrow's prices, most people base their expectations on yesterday's prices. A change in the expectations regarding money's future purchasing power can of course occur – but this requires an expansion in the money supply, i.e. it is not possible for such expectations to form *unless* a preceding increase in the money supply causes a fall in the demand for money.

To this point Mises remarks:

> *“The basis of all judgments concerning money is its purchasing power as it was in the immediate past. But as far as cash-induced changes in purchasing power are expected, a second factor enters the scene, the anticipation of these changes.*
>
> *He who believes that the prices of the goods in which he takes an interest will rise, buys more of them than he would have bought in the absence of this belief; accordingly he restricts his cash holding. He who believes that prices will drop, restricts his purchases and thus enlarges his cash holding. As long as such speculative anticipations are limited to some commodities, they do not bring about a general tendency toward changes in cash holding. But it is different if people believe that they are on the eve of big cash-induced changes in purchasing power. When they expect that the money prices of all goods will rise or fall, they expand or restrict their purchases. These attitudes strengthen and accelerate the expected tendencies considerably.*
>
> *This goes on until the point is reached beyond which no further changes in the purchasing power of money are expected. Only then does the inclination to buy or to sell stop and do people begin again to increase or to decrease their cash holdings.*
>
> *But if once public opinion is convinced that the increase in the quantity of money will continue and never come to an end, and that consequently the prices of all commodities and services will not cease to rise, everybody becomes eager to buy as much as possible and to restrict his cash holding to a minimum size. For under these circumstances the regular costs incurred*

> *by holding cash are increased by the losses caused by the progressive fall in purchasing power. The advantages of holding cash must be paid for by sacrifices which are deemed unreasonably burdensome.*
>
> *This phenomenon was, in the great European inflations of the 'twenties, called flight into real goods (Flucht in die Sachwerte) or crack-up boom (Katastrophenhausse)."*

(our emphasis)

Human Action, ch. XII, 8

Expectations *alone* can not possibly lead to a rise in the 'general level of prices' or to a general fall in money's purchasing power. Unless the money supply is first increased, consumers will simply not be able to increase their monetary spending on goods. We can be highly confident that if the money supply were to remain stable, no such expectations about a future decline in money's purchasing power would form.

However, as Mises notes above, things become problematic once expectations of a continuing fall in money's purchasing power do indeed form and become widespread. In that case, the *demand* for money will eventually fall precipitously, as the expected future losses of purchasing power will make cash holdings a proverbial 'hot potato'. This process can take many years, i.e. , it may take some time before people's expectations are reshaped in this manner. In the worst case – that of a hyperinflation – the demand for money can fall so quickly that prices discount the expected future loss of purchasing power to such an extent that existing cash holdings are no longer sufficient to pay these prices. Eventually a complete breakdown occurs – no-one wants to give away anything for the money concerned anymore.

However, the important point that needs to be stressed is that the expansion of the money supply comes *first*. Only when people begin to believe that this expansion will continue and will possibly accelerate beyond all bounds, will expectations of the future loss of purchasing power become large enough that the demand for money begins to notably decline.

We would remind readers here of a historical phenomenon that has been observed in all cases of inflationary monetary breakdowns: at some point, the monetary authority would announce (whether it was Germany's Reichsbank under Rudolf von Havenstein or Zimbabwe's Reserve Bank under Gideon Gono) that it was 'forced to increase its note issuance in order to combat a growing shortage of cash'. This type of announcement has always been a sure sign that the underlying currency system was in the process of disintegration.

Having said all that, perhaps today's central bankers are actually right in worrying about inflation expectations. After all, the evidence shows that they have indeed increased the money supply enormously and continue to do so. It seems possible that the inflation that has *already* occurred will have an effect on inflation expectations with a certain time lag, especially if the inflationary policy continues at full blast. On the other hand we note that at present, the commercial banks are not especially eager to expand their inflationary lending. The current policy, pursued especially by the Fed and the BoE, consists of the monetization of existing government debt, which in turn allows the government to borrow large additional amounts from both the commercial banks and non-bank investors. This is of course no less damaging than an increase in fiduciary media on account of inflationary lending by the banks to the private sector – in fact, it may well prove to be even more dangerous. One factor that could play a role in shaping future inflation expectations in this context is the size of government's deficit relative to government's revenues. If the idea that the shortfall can only be financed with the printing press becomes widespread and ingrained, then a sudden reappraisal of the future purchasing power of money by a critical mass of people could well ensue.

An additional point worth considering is that after the faltering of the boom in 2007/8, much of the private sector remains in 'debt retrenchment mode', which is an inherently deflationary force (if more money is paid back then lent out , this will lead to a decline in the money supply in a fractionally reserved system). Therefore, central bankers pursuing a 'stabilization policy' will be even more inclined to counteract these tendencies by increasing the pace of monetary pumping – in fact this is precisely what we could so far observe.

Charts by: Shadowstats.com, Michael Pollaro

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