Social Education 77(2), pp 87–90

Visions of Inflation in World History: Ghost Story III*

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* *This article represents the third in a "ghost story" series by the same authors. Readers may recall that Mr. Bernanke was "visited" by the ghosts of Adam Smith and John Maynard Keynes in the March/April 2010 issue of* Social Education *as these two famous economists debated the economic recovery. Mr. Bernanke was visited once again by the ghosts of John Maynard Keynes and Milton Friedman in the March/April 2012 issue of* Social Education *and discussed the then new quantitative easing policy of the Fed.*

Why Worry about Inflation?

Inflation has been present for as long as societies have used money. Stories of economic calamities in world history frequently credit inflation as their source. The United States' last big showdown with inflation dates back several decades, to the sluggish 1970s. After growing at nearly 4.5 percent in the 1950s and 1960s, the U.S. economy grew at an average of only about 3 percent in the 1970s. In the meantime, inflation surged unexpectedly. And so did unemployment. Americans experienced double-digit inflation in the years of 1974, 1979, and 1980. Presidents attempted to design policies to remedy the problem without success. Inflation defeated the actions of three U.S. presidents—Nixon, Ford, and Carter. It took a mix of extreme actions of Federal Reserve Chairman Paul Volker to finally break the inflation problem. These monetary policies came at a high cost. Volker pushed interest rates to over 20 percent, induced a deep recession, and nearly destroyed the housing market. In fact, angry homebuilders sent him two-by-fours in the mail. Finally, however, inflation was once again under control, which set the stage for decades of economic expansion.

While many nations have experienced rounds of high inflation, others have endured crushing rounds of hyperinflation. What is inflation? Inflation is defined as a sustained rise in the general level of prices. But, not every price increase represents inflation. When the price of coffee increases because of a crop failure in Brazil, that is a specific price change due to supply and demand of a particular good. At the same time as that Brazilian coffee crop failure, there might be supply improvements for eggs or vegetables that push their prices down. Only when the average of all prices is going up do we have an actual inflation, defined as "a sustained increase in average prices across the economy."

What about hyperinflation? The difference between inflation and hyperinflation is one of degree. Typical inflation levels do not significantly alter people's behavior. In contrast, hyperinflation, commonly defined as an overall price increase greater than 50 percent per month,[1] forces people to adjust. Hyperinflation is typically caused by a very rapid increase in the supply of money in an economy relative to the production of goods and services. This money printing causes the value of each unit of the currency to fall and prices necessarily skyrocket. Because the value of the money is declining at warped speed, people can't spend it fast enough. Normal economic behavior is replaced by panic spending. Saving and investing becomes pointless and the economy frequently collapses.

Have the nations of the world learned to avoid hyperinflation? Table 1 (on p. 88) shows that the world's largest economies have experienced relatively low levels of inflation recently. Japan continues to struggle with a different problem called deflation or a declining overall price level. However, low levels of inflation are not universal. In 2011, Iran experienced yearly inflation of almost 21 percent, Sudan 18 percent, and Venezuela led the world with prices rising at over 26 percent per year.

Table 1: **Inflation Rates among World Economies**

World Inflation and Inflation in the World's Largest Economies	2011 Estimated Rate of Inflation (percents)
World	5
United States	3.1
China	5.5
Japan	- 0.3
Germany	2.5
France	2.3
United Kingdom	4.5
Brazil	6.6

Source: Central Intelligence Agency. The World Factbook (see: **https//www.cia.gov/**)

Central Bankers Meet at Jackson Hole in 2012

Since 1978, the Federal Reserve Bank of Kansas City has hosted an annual economic policy symposium. The event is designed as a forum for central bankers, policy experts, and academics to examine emerging issues and trends in the world and in key economies. Since 1982, the meetings have been held in Jackson Hole, Wyoming, a picturesque location known for its mountain views and terrific trout fishing.

While the Wyoming venue may appear calm and relaxed on the surface, the meetings themselves involve high stakes. In 2012, Federal Reserve Chairman Ben Bernanke was joined by financial leaders from around the world including representatives from the Bank of England, Bank of Japan, Bank of Israel, as well as others from Sweden, Iraq, Turkey, Mexico, Ireland, Brazil and many more.

Our "ghost story" picks up here, on the first night of the conference, with Bernanke slipping away from his colleagues to turn in early. For weeks, he and his staff had been preparing for these meetings. His speech was ready. Now, he wished to get a good night's sleep and be well rested for the next day's events. He was asleep before his head hit the pillow, and he drifted into a deep dream. In it, he recalled his encounters with two late great economic thinkers: the British economist John Maynard Keynes, whom he met only through books, and Milton Friedman, whom he knew personally. Bernanke remembered studying Keynes's arguments for government intervention when the economy slows. And he recalled conversations with Milton Friedman in 2002 at Friedman's 90th birthday celebration. In the twentieth century, Keynes was the most prominent advocate of active government management of the economy and Friedman was the most noted champion of free markets. Friedman was also known for being a monetarist—a school of economic thought that emphasizes the role of the money supply on the economy.

Ben's Dream

Bernanke's dream that night may have gone something like this:

Bernanke: Could it be? Milton, my friend, it is good to see you after such a long time.

Friedman: Greetings, Ben. The pleasure is all mine.

Bernanke: And is that John Maynard Keynes standing before me?

Keynes: I am always ready to help when a major economy slows.

Bernanke: You know, Milton, I never have forgotten your famous statement: "Inflation is always and everywhere a monetary phenomenon, in the sense that it cannot occur without a more rapid increase in the quantity of money than in output."[2]

Keynes: If I had been alive when you said that, Milton, I would have disagreed. "Always and everywhere" a monetary phenomenon? With your exclusive focus on money, you are ignoring some important forces. If an economy is running fast, near full employment, of course money will lead to inflation. But if it has a lot of slack, money can be increased without leading to inflation. Didn't you chaps ever teach economic history?

Friedman: Of course I did. I always enjoyed pointing out how, during the days of the Roman Empire, the currency was devalued. The economy was approaching collapse due to the inability of tax revenues to keep pace with spending by government bureaucrats and the military. Roman Emperor Diocletian—not unlike President Nixon—attempted to address the problem through price and wage controls, but those, of course, only made matters worse by causing widespread shortages on all sorts of goods and services.

Keynes: Ah, incompetent price controls. None of us favored those. But in my time I tried to show leaders that the government had to manage the total demand of an economy—what you call "aggregate demand" today. That's as important as managing money.

Friedman: You're not saying money is unimportant in determining inflation, are you?

Keynes: Not at all. Money is especially important in cases of hyperinflation. Do you remember the inflation of the Weimar Republic that I wrote about in *The Economic Consequences of the Peace*?[3] I pointed out that Germany's reparations for World War I were excessive and the peace treaty too vindictive. When Germany had to pay those reparations, it faced large deficits and had little alternative but to print more paper money in order to satisfy its debts.

Friedman: But, of course, as we both know, there was much more to the story. Part of the problem was that Germany did not have access to the international bond markets during the war. New York, London, and Paris were off limits. While Berlin and Vienna were important financial centers, it was not enough. After they had sold all the bonds they could internally, Germany and its allies turned to central banks to increase the money supply by issuing Treasury bills. This helped set the stage for the later inflation.

Keynes: And, then, of course, things got much worse. Germany was defeated. Those who had bought war bonds lost out as the nation faced bankruptcy. The Weimar Republic spent recklessly, running large deficits and facing the burden of excessive reparations. You know, Milton, sometimes people say I'm too tolerant of inflation, but I did say in *The Economic Consequences of the Peace*: "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."

Friedman: There we agree. One might think that the experiences of the Weimar Republic would have been a stern message to governments around the world to act quickly to prevent runaway inflation. Argentina was, in 1913, one of the wealthiest economies in the world. Yet, it never lived up to those early expectations.

Keynes: Yes, I had high hopes for Argentina. It had great resources and an excellent workforce. All that country needed was good leadership and a will to manage the economy's total demand. But near the end of my life, I was troubled by the rise of that young military officer Perón.

Friedman: Yes, Juan Perón. His quasi-fascist policies helped set the stage for economic disaster. He favored tariffs to protect Argentinean industrialists and generous wages and benefits to Argentinean workers resulting in large deficits. While many regimes followed Perón (who returned two more times as president), Argentina's government leaders showed little interest in restraining spending.

Bernanke: May I jump in, guys? I remember well what happened in Argentina in 1989. After years of massive budget deficits that were financed with borrowing from abroad and from Argentinean citizens, the country was left with so much debt and no other country willing to lend it any more money, the leaders felt compelled to resort to the printing press. In July 1989, Argentina saw 200 percent inflation for the month, peaking at 5,000 percent for the year. As prices increased, real wages fell by almost half. Milton, that made me even more convinced that you monetarists were right about hyperinflation.

Friedman: Yes, 1989 was a disaster. In addition, Argentina's serial defaults on its debts in 1982, 1989, 2002, and 2004 did little to foster international confidence in investing in Argentina.

Keynes: But remember, in Argentina we're talking about massive increases of government spending and money, not the careful management of economic ups and downs such as I recommended.

Friedman: Should we worry that the policies of the Fed today may result in large increases in the rate of inflation sometime in the future?

Keynes: Oh, poppycock, Milton. There is a lot of unemployment—and many underused resources— in the U.S. economy today. Increasing the economy's total demand is just the right thing to do now. You can worry about inflation when you get closer to full employment. Ben, surely you're not worried about inflation?

Bernanke: I have to worry. As both of you know, I have a job to do. The Fed has a dual mandate—stable prices and high employment. Our current policies—which include buying mortgage-backed securities and treasury bills from banks—are intended to lower long-term interest rates. That should encourage investors to buy assets with higher returns and greater risk, such as stocks and corporate bonds. The idea is to get the economy moving again and reduce unemployment.

Friedman: But, will it work? The last round of quantitative easing (QEII) succeeded in increasing stock prices for a time so some people felt wealthier. But it also increased prices for other items like energy and food. This raised costs for businesses and made consumers feel poorer. Meanwhile, the unemployment rate remained high and economic growth sluggish. Doesn't sound like a huge success to me.

Keynes: You fellows are still worried about the amount of money, when you should be focusing on the total demand for goods and services. If you ask me, I say you should do additional stimulus with public works projects. That will pep up aggregate demand. And, can't you do something about housing with your monetary policy?

Bernanke: Actually, I'm optimistic that the biggest impact with our new round of easing will be seen in the housing market. Many homeowners have been unable to benefit from low interest rates because banks have been reluctant to write new loans. If banks are not lending this money out, it never enters the economy. Theoretically, this money never becomes part of the money supply and therefore does not have an effect on the rate of inflation. Millions of people have been unable to refinance because they owe more than their homes are worth. Buying mortgage-backed securities from banks will free them up to do more lending and help the recovery of the housing market.

Keynes: Ben—may I call you Ben?—I have one main fear about your continued low interest rate policies. Your government is carrying a lot of debt now, not unlike some famous troubled economies in history. When interest rates increase, as you know they will, the national debt will soar from interest payments alone. That will displace spending for all sorts of other important government functions from courts to roads to education. I have always been for well chosen government spending projects.

Friedman: I have only one fear, Ben. You've been expanding the amount of money a lot. Any monetarist has to worry about that. Will you be able to unwind from your expansionary policies at exactly the correct time to avoid touching off a round of serious inflation? You're good Ben, I just don't think you're that good.

Conclusion

Bernanke awoke from his dream, reminded that well-known economists of today are not unanimous concerning his policies. On the one hand, many support the Fed's actions, arguing that the continued weak economy provides the impetus for such monetary action. Economists of this opinion further argue that at a time of government gridlock—and without a consistent fiscal policy response from Washington—the Fed must act to stabilize the economy. In contrast to the Fed's actions during the Great Depression, the current Fed has behaved in an activist manner that they would argue is consistent with their dual mandate of stable prices and high employment. That is, as long as unemployment remains high, the Fed has a duty to act.

Other economists worry that the Fed's actions are bound to lead to high inflation in the future. The Fed has more than doubled its balance sheet since the economic calamities of 2007; this kind of increase in the supply of money has been known to cause serious inflation many times in recent history. Is Friedman right? Is it true that "Inflation is always and everywhere a monetary phenomenon"? The United States has not yet experienced significant price increases and the Fed can, of course, reverse its policies should inflation become an issue. In the end, perhaps the real question is whether the Fed will be willing and able to act quickly enough. It's enough to give a Federal Reserve chairman nightmares.

Notes

1. N. Gregory Mankiw, *Principles of Macroeconomics* (Mason, Ohio: Cengage Southwestern, 6th ed. 2012), 356.
2. Quoted in Peter Coy, "Milton Friedman: Death of a Giant," *Business Week* (November 17, 2006), www.businessweek.com/stories/2006-11-17/milton-friedman-death-of-a-giantbusinessweek-business-news-stock-market-and-financial-advice
3. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt Brace and Howe 1920).

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