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The cause of inflation, its link to unemployment and the need for sound monetary control

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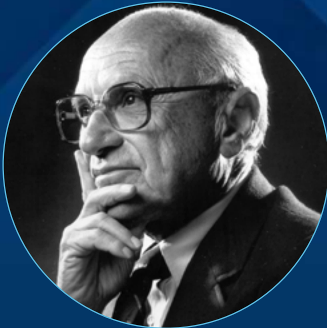
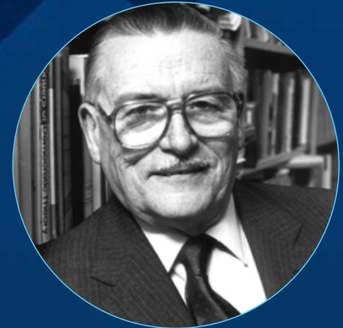


Milton Friedman

Friedrich A. von Hayek



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1. Defining Inflation

When we think about the word *inflation*, our mind immediately goes to an increase in the price level and, after that, we figure out that our purchasing power is deteriorating, that somehow we are poorer. It is enough to check the popular definitions of inflation that can be found on *Wikipedia* and *Investopedia* to see how the common understanding about inflation has shaped also formal definitions. According to *Wikipedia*, in economics "inflation refers to a general progressive increase in prices of goods and services in an economy. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation corresponds to a reduction in the purchasing power of money". (https://en.wikipedia.org/wiki/Inflation). Similarly, *Investopedia* explains that inflation "is the decline of purchasing power of a given currency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time. The rise in the general level of prices, often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods" (https://www.investopedia.com/terms/i/inflation.asp). For clarity we accept that inflation is any one-off or continuing rise in the average level of prices.

Moving into greater depth, traditional textbooks distinguish between demand-pull inflation and cost-push inflation. The first case is the one of an excess of aggregate demand caused by an increase of the total demand for goods and services such that the aggregate demand is above the potential production capacity; according to the same textbooks, this can be the case of an increase in consumption, an expansion of credit or deficit spending (Baranzini and Marangoni, 1995, pp. 272-273). Cost-push inflation, instead, would be an increase in prices due to an increase in the costs of productive factors higher than the increase of their productivity (Baranzini and Marangoni, p. 274) or rises in the raw materials used in the production process, the costs of energy or transport.

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However, such definitions can be considered a misuse of the term inflation. It is true that policymakers find it convenient to accuse businesspeople, trade unions or even consumers for causing the inflation. But all "these can produce high prices for individual items; they cannot produce rising prices for goods in general. They can cause temporary ups or downs in the rate of inflation. But they cannot produce continuing inflation for one very simple reason: none of the alleged culprits possesses a printing press on which it can turn out those pieces of paper we carry in our pockets; none can legally authorize a bookkeeper to make entries on ledgers that are the equivalent of those pieces of paper" (Friedman and Friedman, 1980, pp. 253-254).

Instead inflation's "original and proper meaning is an excessive increase in the quantity of money, leading in turn to an increase in prices" (Hayek, 1979, p. 44). This clarification is very important, in particular today when monetary and political authority keeps on blaming supply-side shocks (in turn generated by COVID-19 responses such as stay-at-home orders) for the average price increase we are experiencing, with no mention of the increase in money supply beyond the rate of growth of output and how they are generated by policies implemented to address the scars created by those stay-at-home orders. All mention of government deficit spending and expansive monetary policies are ignored.

Therefore, we may say that inflation is produced by "a more rapid increase in the quantity of money than in the quantity of goods and services available for purchase, and such an increase raises prices in terms of that money" (Friedman and Friedman, 1980, p. 252).

This is best explained by Milton Friedman in the First Wincott Memorial Lecture entitled *The Counter-Revolution in Monetary Theory* (Friedman, 1970): "Briefly stated there is a consistent though not precise relationship between the rate of growth of money and the rate of growth of nominal national income. Today's income growth depends on what has been happening to money in the past".

This lagged relationship between a change in monetary demand and change in nominal national income takes approximately 6-9 months and may take up to 18 months to show up as inflation. Giving the last words to Friedman, he said that "Inflation is always and everywhere a monetary phenomenon in the sense that it is, and can be, produced only by a more rapid increase in the quantity of money than in output". We will come back to this in Section 3.

2. Is there a cost-push inflation?

What we have seen in the first section seems in contradiction with the predominant narrative that tends to identify rising costs as the cause of inflation. How did "the myth" of a cost-push inflation come into place? The story we are going to tell applies to every country with a government and a Central Bank and is perfectly illustrated by what happened and is happening in the UK economy. No doubt someone will check this but to the best of our knowledge no economics textbooks before Keynes death in 1946, or a hazard at a guess, before the 1960s included a reference to cost push as a cause of inflation.

Throughout the 1960s Keynesians were pushing to test their countercyclical policy theory but each time the government went for a fiscal stimulation they were baulked by the fixed exchange rate. Boosting domestic aggregate demand sucked in imports, the current account of the balance of payments went into deficit putting pressure on the exchange rate as the currency was then overvalued. At this point in time the fiscal stimulation was stopped and then started again when the economic environment improved or often just before the next election. What we saw in the 1960s was a Stop-Go Cycle which should more accurately have been described as a Go-Stop Cycle.

However, in 1971 the Gold Exchange Standard which had underpinned the fixed exchange rate system was suspended permanently and currencies were floated on foreign exchange markets. This gave Keynesians their chance as they were no longer constrained by a fixed exchange rate. A plan was established to complete a fiscal stimulation policy designed not only to reach full employment but to achieve a 5% pa target for economic growth. The outcome of this policy is explained in the easy-to-read attached article entitled (see Appendix 1).

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After an initial boom in 1971/2, the Keynesian theory began to unravel as successive budget deficits caused inflation to start rising. A brief explanation is required here. There are two ways of financing a budget deficit. One is not inflationary when the debt is sold on private financial markets to real people, the other has the potential to be inflationary as the debt is left unsold at the Central Bank and new money is printed to the value of that debt. By 1977 inflation had reached 26% pa, unemployment was high and economic growth was almost non-existent. The target of a 5% yearly growth target had turned out to be 0.6% pa. These are the characteristics of stagflation and not what should have happened according to Keynesian theory.

Keynesian theory explains how fiscal stimulation will create jobs and promote growth with little risk of inflation as long as there is an output gap between actual output and planned full employment output. When questioned on why inflation was accelerating and the output gap was not closing, the Keynesians explained that inflation was not the result of demand-pull inflation as output was not at its full potential and unemployment was high. This was in fact the mythical cost-push inflation caused by large rises in crude oil prices, wage rises and a falling exchange rate which was pushing up import prices. At that time the UK government sent out a leaflet to every household entitled *Attack on Inflation: A Policy for Survival* (Government of the United Kingdom, 1975). In the leaflet

they wrote that "No reasonable person can put all the blame for runaway inflation on wage rises or the Trade Unions. There are many other causes. There was a steep increase in 1972/3 in world costs of food and raw materials and the colossal rise in oil prices in 1973/4".

Note that there is only reference to cost-push factors. Throughout the leaflet there is no reference to the actual cause of inflation, as we understand it, which is explained below. Across the decade of the 1970s Keynesians were saying that there was deficient aggregate demand, high cost-push inflation and damaging supply side shocks to the economy. This was all wrong and takes us to the point where we establish that cost-push inflation is a myth.

Inflation, instead, by definition measures more units of money used in the same number of transactions. It would be impossible to have inflation in a barter economy as every price rise would be matched by an equal and opposite fall in prices. Oil companies, farmers, miners and importers cannot increase the number of units of money in an economy, only the Central Bank in a fiat money economy can do that. Central Banks have total control over the supply of currency (counterfeiting apart) in the economy and they take responsibility for managing the quantity of money that can be created by private sector banks. This means that Central Banks are the sole cause of inflation. It just cannot be any other way.

3. The Monetary Nature of Inflation

The relationship between the increase in the quantity of money (higher than the increase in output) and rising prices is thus here crucial for the proper definition of inflation. As explained by Hayek (1979, pp. 44-45), "a general rise in prices, for instance one brought about by a shortage of food caused by bad harvests, is not inflation. Nor could we properly call "inflation" a general rise in prices caused by a shortage of oil and other sources of energy that led to an absolute reduction of consumption, unless this shortage had been the pretext for a further increase in the quantity of money. There may also be inflation that considerably harms the working of the market without any rise in prices – if the rise is prevented by controls. Indeed such a "repressed" inflation tends to disorganize economic activity even more than open inflation". It is no surprise that there was no recorded inflation after the Russian revolution (1917) as all prices were fixed and the allocative mechanism became shortages and queuing.

Therefore, inflation "occurs when the quantity of money rises appreciably more rapidly than output, and the more rapid the rise in the quantity of money per unit of output, the greater the rate of inflation" (Friedman and Friedman, 1980, p. 254).

Even Keynes (1936, Chapter 21) recognized that "prices are governed by the quantity of money, by its income-velocity, by the velocity of circulation relative to the volume of transactions". However, it was from this book that Keynesians began to express another cause of inflation, not cited by Keynes himself, namely cost-push inflation (Hearn, 1979).

In a nutshell: according to our view, which is shared by Monetarists and, to a certain extent, by the Austrian School of Economics, the only one cause of inflation is too much money chasing too few

goods. In contrast Keynesians, and incidentally most textbooks on economics, identify two causes of inflation which are demand-pull and cost-push.

It is also important here to repeat that today, "when the commonly accepted media of exchange have no relation to any commodity, the quantity of money is determined in every major country by government. Government and the government alone is responsible for any rapid increase in the quantity of money" (Friedman and Friedman, 1980, p. 253).

Not recognizing this will impede a clear understanding of the cause of inflation. It goes without saying, policymakers are quite reluctant to accept responsibility for producing inflation, and indeed they tend to look away from the actual cause and search for different excuses. As previously mentioned, in the current scenario politicians blame supply-side disruptions for the growing level of inflation. In other situations, they have found it easy to accuse businesspeople, trade unions or even consumers for inflation. But all "these can produce high prices for individual items; they cannot produce rising prices for goods in general. They can cause temporary ups or downs in the rate of inflation. But they cannot produce continuing inflation for one very simple reason: none of the alleged culprits possesses a printing press on which it can turn out those pieces of paper we carry in our pockets; none can legally authorize a bookkeeper to make entries on ledgers that are the equivalent of those pieces of paper" (Friedman and Friedman, 1980, pp. 253-254).

4. Inflation and Unemployment

To stress the monetary nature of inflation and the role of government in producing inflation is important that these changes in the quantity of money not only affect the general price level, but, and probably most importantly, they alter the structure of relative prices, which is the source of "the most harmful effects of inflation: the misdirection of resources it causes and the unemployment that ultimately results from it" (Hayek, 1979, pp. 42-43).

As recognized also by Friedman (2007, p. 17), a "second related effect of increased volatility of inflation is to render market prices a less efficient system for coordinating economic activity". In fact, as explained by Hayek (1945), the price system transmits information that allows economic agents to decide what to produce and how to do so in this regard, the central role is played by the structure of relative prices. But, the "more volatile the rate of general inflation, the harder it becomes to extract the signal about relative prices from the absolute prices: the information about relative prices is, as it were, being jammed by the noise coming from the inflation broadcast" (Friedman, 2007, p. 17). The "jam" in the information transmission mechanism generates a misallocation of resources which in turn is at the root of unemployment and stagnation in the economy.

The relationship between money creation, inflation and unemployment is a crucial one. In fact, for a certain number of years the so-called *Phillips Curve* dominated the analysis and brought about the acceptance of "a stable negative relation between the level of unemployment and the rate of change of wages" (Friedman, 2007, p. 4). It is interesting to note that the Phillips Curve was wages linked to unemployment, not prices linked to unemployment. Arguably the Keynesians used the cost push myth to translate wages into prices. This is a step too far for

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monetarists. Empirically the Phillips Curve was a relationship and trade-off between wages and unemployment: high unemployment and wages fell, low unemployment and wages rose. The Keynesians then hijacked the curve to suggest the higher inflation created more jobs and deflation more unemployment. In short, Keynesians assumed the Phillips Curve was showing a trade-off between unemployment and inflation: somehow – it was believed – inflation is the price that we need to pay to increase employment. The emergence, in the 1970s, of stagflation as a mix of inflation and stagnation (unemployment and no growth) has challenged the traditional theoretical paradigm which shaped most of post-WW2 full-employment policies, inspired by the preaching of John Maynard Keynes. How did these policies become so fashionable?

As explained by Hutchison (1977), there is no evidence of cost-push inflation in Keynes writings and only a hint that cost-push pressures may change relative prices. It is therefore necessary to investigate where the idea originated that cost-push could change average prices and cause inflation.

Firstly, we need to understand the macroeconomic concept of a countercyclical policy. For the years before World War Two economists believed that a capitalist economy was naturally unstable and fluctuated between booms and depressions

in a regular cyclical way. More to the point was the fact that a government's budgetary policy (not yet fiscal policy) reinforced this cycle. When the economy was recovering and moving towards a boom, government revenues would increase and the government spent more money which encouraged the boom to continue into overheating territory. However, when the economy slumped into recession and depression government revenues fell and the government spent less and the economy contracted further.

Keynes and the Keynesians were in agreement that the budget could be used as a fiscal policy, in a countercyclical way that would reduce the amplitude of the cycle and smooth economic activity. When the economy was tending towards contraction and government revenues were falling then they should spend more and run a budget deficit where government spending exceeds taxation and is covered by a borrowing requirement. In contrast when the economy was expanding rapidly and at risk of overheating then the government should not increase its spending as its revenue grew effectively running a budget surplus with government revenue exceeding its spending.

As a theory the logic is impeccable if the economy was naturally cyclical and aggregate demand was rising and falling with the cycle; then, to use a favourite Keynesian analogy, the government could act like a thermostat in a central heating system by turning it off when it is becoming too hot (Budget Surplus) and turning back on again when it is cooling down (Budget Deficit). This smoothing of aggregate demand could theoretically be managed at a high level of employment which Keynesians would refer to as the full employment equilibrium.

The point we make here, instead, is that those policies are harmful and generate a vicious cycle of inflation and unemployment. However, it is important to clarify here that higher government spending "will not lead to more rapid monetary growth and inflation if additional spending is financed [...] by taxes". Even spending financed by a deficit is not inflationary if the money is borrowed

from real people as when government has more to spend, the public has less and higher government spending is matched by lower private spending for consumption and investment (Friedman and Friedman, 1980, p. 264). The nature of deficit spending only becomes inflationary when money is printed against that debt. As it is easy to understand, taxation is politically unattractive as is borrowing from the public that would produce a rise in the interest rate, making it more difficult for individuals to honour their debts. Therefore, as explained above and below certain borrowing is unattractive, at least in the long run, and may lead to slower growth and to economic difficulties for the public. The obvious option is to finance some of the debt with printed money, cause inflation the following year and blame it on cost push inflation.

In a situation where debt is sold to real agents then the government, by issuing additional debt, pushes up the interest rate. This has two consequences: on the one hand, the supply of loanable funds rises (savings are attracted by higher interest rates); on the other hand, because of the increased interest rate, demand for investments in the private sector decreases. "While a subsequent rise in interest rates may elicit some increase in the amount of total saving in the economy, the residual amount of saving available to meet the private-sector demands for loanable funds will fall. Utilization of savings by government to finance its deficit will crowd out utilization of savings for private investment" (Buchanan and Wagner, 1977, p. 69)

Because a high interest rate reduces the profitability of long-term projects, resources are reallocated away from more remote stages of the production process to the benefit of production of consumer goods; this is because of the increased demand for these goods. This reallocation is the result of additional debt. This means that "with a reduced rate of investment, the economy grows at a slower rate, impinging negatively on the consumable output available in the future. To this extent, the debt burden is shifted forward" (Garrison, 2001, p. 87). This does impose costs on future generations.

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The final result of borrowing is a slower growth rate. In general, according to White and Garrison (1999, p. 8), it is vital to emphasise the difference that arises when the government obtains resources through bonds or taxation. This difference is very important for two reasons. Firstly, the level "of spending may in fact rise with the extent of deficit financing"; a greater recourse to debt *may* mean lower taxation on all citizens *today*, but by shifting "some of the burden of current government spending onto future voters who are inadequately represented in today's borrowing decisions". This means that, in this way, a high level of spending implemented by recourse to debt is politically very appealing for governments.

The second reason is that borrowing can be transformed into a vicious cycle, an endless affair, especially if the securities are purchased by the central bank, which, by monetising them, creates even more distortion in the money supply. In fact, it will create a situation of general uncertainty over the times and ways in which the Government will repay its debt. In this way, government borrowing/indebtedness increases the risk for activities in the private sector.

Therefore, governments often resort to increasing the quantity of money in order to finance full employment policies. The increase in the quantity of money allows politicians to support these policies without imposing new taxes and this is the actual cause of inflation.

As explained by F.A. von Hayek (1950), not only full employment policies so financed produce inflation (see also Friedman and Friedman, 1980, p. 266); they also fail to produce persistent employment because the modification of the structure of relative prices generated by inflation will make unemployment worse, after only temporary relief induced by those policies. The Austrian economist's central thesis is that short term injections of money may well help maintain jobs temporarily at a higher level than would be possible otherwise; nonetheless, in the long term, the employment level resulting from these policies is destined to fall.

While it is true that an increase in monetary incomes may temporarily increase employment, the basic mistake is to believe that unemployment is due to insufficient aggregate demand and that pressure on it may therefore automatically generate employment (Hayek, 1950, p. 176). If spending is spread across the various sectors in a manner other than that in which employment is spread in the same sectors, then it cannot be assumed that an increase in spending has a positive effect on employment.

Hayek (1950, p. 177) explains that unemployment can "be the consequence of the fact that the distribution of labour is different from the distribution of demand. In this case the low aggregate money income would have to be considered as a consequence rather than as a cause of unemployment. Even though, during the process of increasing incomes, enough expenditure may "spill over" into the depressed sectors temporarily reducing unemployment, but as soon as the expansion comes to an end, the discrepancy between the distribution of demand and the distribution of supply will again show itself. Where the cause of unemployment *and* of low aggregate incomes is such a discrepancy, only a re-allocation of labour can lastingly solve the problem in a free economy".

In this scenario, monetary expansion directs demand towards sectors that, without exogenous stimulation, would not be favoured. When such expansion comes to an end, probably because inflation has reached an unsustainable level, demand will be forced to

return in the direction expressed by the temporal preferences in existence prior to monetary manipulations; inasmuch, employment created artificially in all probability will not be permanent. The new unemployment level may even be higher than the pre-stimulus situation, if monetary injections encouraging demand have not only increased employment but have also stimulated the creation of new economic initiatives in the sectors so stimulated. This is why the result of inflation is worse than the problem intended to be resolved.

The problem is that unemployment created by inflation (in turn created by the government) can be governed only by a growing level of government control. This means a further decrease of economic and action freedom, as well as higher inflation, so that governments can control the population and keep it "happy" only through further full employment fiscal stimulation policies supported by accommodating monetary injections. Once begun, this vicious circle seems to be very difficult to halt. The two possible outcomes may well be revolution (because employment and income levels are no longer sustainable) or total control. It would have been better to act differently right from the beginning.

At this point let us draw things together. There is only one cause of inflation and that is the Central Bank expanding monetary demand faster than output. Keynesians identifying cost push causes is incorrect and is seen as an attempt to explain how unemployment remains high given rising inflation. We are saying that all inflations must be the result of excessive monetary demand irrespective of the level of employment or unemployment.

5. Explaining the COVID-19 Inflation

The rise in prices emerging with the post-lockdown economic recovery can be easily explained within the framework we have used so far.

All governments increased their expenditure significantly in the attempt to fight the spread of the virus and support the health of their people at a time when there was no increase in taxation to finance it. The result was an increased borrowing requirement which many countries chose to support by increasing the money stock (M). In the United Kingdom, United States and European Union, this was clearly seen in the Quantitative Easing programmes. At the same time stay-at-home orders, lockdown and suppression policies slowed the velocity (V) of circulation of money.

The immediate effect on monetary demand M x V was indeterminate, with stock rising but flow declining; however, as countries moved back towards some type of normality, so did velocity and monetary demand began to increase and to outpace a stagnant economy. Given a time lag which may be 12-24 months from the time of the increase in money stock (lengthened due to a temporarily slowed velocity) we can confidently expect inflation to increase in a stagnant economy giving countries a period of stagflation. At the date of writing (November 2021) we can see inflation picking up and currently standing well above most Central Banks inflation targets.

The inflation occurring now was caused by the excessive expansions in monetary demand which started last year. However, governments and Central Banks wish to absolve themselves of the responsibility for this inflation in the same way that they did in the 1970s. They pick on the prices that are going up most in the basket used to measure inflation and draw attention to them as a cause.

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This is the cost-push myth rising again. Higher oil prices, energy, food, transport costs and supply chain hiccups are not the cause of inflation they are the symptoms. This was discussed with the Bank of England when they were accused of misleading people in their Inflation Reports. Their response was to say that they do highlight prices that are rising faster and news outlets usually misinterpreted their description as causal. The Bank does not identify these price rises as the cause.

How long will the current higher than target inflation continue? The answer is simple. It is for as long as the growth in monetary demand is faster than the growth of output thus causing the average level of prices to adjust upward.

We must not confuse the changes in relative prices that occur all the time with the cause of a change in the average level of prices.

6. Addressing Inflation

Once inflation has been fuelled by full employment policies financed with the printing press or by the monetization of debt, the only few choices available are: "1. To allow a rapidly accelerating inflation to continue until it has brought about a complete disorganization of all economic activity. 2. To impose controls of wages and prices that would for a time conceal the effect of a continued inflation but would inevitably lead to centrally a centrally directed, totalitarian economic system. 3. To terminate resolutely the increase in the quantity of money – a step that would soon, through the appearance of substantial unemployment, make manifest all the misdirection of labour that the inflation in the past years has caused and that the other two procedures would further increase" (Hayek, 1979, p. 4).

It is clear that solutions 1. and 2. are not desirable; but this does not mean that they are unlikely to happen. When inflation is out of control "we will come to see our salvation as residing in the use of power. Power is always sought to promote the good, of course, never the bad. We are being bombarded with increasing intensity with calls for incomes policies, price and wage controls, national planning, and the like. Each of these aims to achieve its objectives by the imposition of new restrictions on the freedom of individuals" (Buchanan and Wagner, 1977, p. 76).

It is equally true that solution 3. cannot avoid a so-called "stabilization crisis", with substantial unemployment. However, while stopping the growth of money, an impending deflation should also be prevented and such an intention should be announced in order to avoid the recession to degenerate into a depression. Secondly, the primary aim should become the stability of the value of money (Hayek, 1979, pp. 16-17). This means bringing about a reduction in the rate of monetary growth, but this entails a problem of political will (Friedman and Friedman, 1980, p. 270).

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In fact, a slower rate of monetary growth following a period of inflation will generate lower economic growth and unemployment. Friedman and Friedman (1980, pp. 270-271) used the analogy of quitting drinking: the process is very painful at the beginning and it produces good effects only in the long run (the opposite of getting drunk, which is pleasant at the beginning and painful in the long run).

Here it is important to clarify that we do not want to give the impression that slower growth and higher unemployment are cures for inflation; no, they are side effects of a cure that wishes to be successful (Friedman and Friedman, 1980, p. 273). Because of the presence of these side effects, it is important to slow inflation gradually but steadily (Friedman and Friedman, 1980, p. 277). However, at the time Friedman said this Hayek disagreed saying that a long drawn out solution would cause politicians to lose their political will to tighten the economy and therefore it would be better to go for the short sharp shock.

There are, however, good reasons to be sceptical about the possibility of a centrally controlled currency supporting such a process of sound control. "Without the conviction of the public at large and the painful measures necessary to preserve reasonable stability, we cannot hope that any authority which has the power to determine the quantity of money will long resist the pressure for, or the seduction of, cheap money" (Hayek, 1976, p. 15).

Therefore, if one of the main problems with regard to a stable money is a government monopoly over supply, then why not allow people to choose freely what money they want to use? Hayek, (1976, p. 17) suggested the countries from the Atlantic Community should "bind themselves mutually not to place any restrictions on the free use within their territories of one another's – or any other – currencies, including their purchase and sale at any price the parties decide upon, or on their use as accounting units in which to keep book".

The reason behind such a proposal is that – in a free currency system – people would refuse to use the national currency if it depreciates and therefore competition would push in the direction of value-stable currencies. "The upshot would probably be that the currencies of those countries trusted to pursue a responsible monetary policy would tend to displace gradually those of a less reliable character. The reputation of financial righteousness would become a jealously guarded asset of all issuers of money, since they would know that even the slightest deviation from the path of honesty would reduce the demand for their product" (Hayek, 1976, p. 20).

The next field of action is, obviously, limiting government spending. "Budgets cannot be left adrift in the sea of democratic politics. They must be constructed within constraints that impose external form and coherence on the particular decisions about size and distribution which an annual budget reflects. The elected politicians, who must be responsive to their constituents, the governmental bureaucracy as well as the electorate, need something by way of an external and "superior" rule that will allow them to forestall the persistent demands for an increased flow of public-spending benefits along with reduced levels of taxation" (Buchanan and Wagner, 1977, p. 182). Such a rule needs to be simple and straightforward, it must offer clear criteria for adherence and for violation and it must reflect and express values hold by the community of citizens (Buchanan and Wagner, 1977, p. 183).

One of the authors of this work is known for advocating balanced budgets over a three-year term until the National Debt is reduced to at least 30% of National Debt, and in "this regard, the simplest rule is to re-establish the primacy and superiority of balanced budgets, which will finally destroy the unhealthy belief in the existence of free lunches" (Buchanan and Wagner, 1977, pp. 184-185). Such a rule should incorporate an automatic adjustment mechanism in the case of budgeted outlays that are projected to exceed tax receipts (Buchanan and Wagner, 1977, p. 185). For example, if the projected balanced budget proves in error "and a budget deficit beyond specified limits occurs, federal outlays shall be automatically adjusted downward to restore projected balance within a period of three months" (Buchanan and Wagner, 1977, pp. 187-188). Eventual surpluses, instead, should be used to retire existing debt.

7. Conclusion

It is not possible for inflation or hyperinflation to be caused by anything other than the rate of growth of monetary demand being faster than the rate of growth of aggregate output. At this point we need a brief note on what is meant by monetary demand which is comprised of two components, that is the money stock (M) and the speed it flows through the economy (V). Therefore, $M \times V =$ aggregate monetary demand.

This means that not only money printing but also accelerating velocity will determine the rate of inflation. This is seen particularly clearly under hyperinflation. As inflation accelerates the value of money falls ever faster and people do not want to hold on to money and therefore pass it on as quickly as possible. An interesting point is that this is reversed under deflation when the value of money is rising.

After this clarification, we can conclude from the analysis conducted so far that the main culprits in generating inflation are the government and monetary authorities, which are responsible for the money supply through fiscal and monetary policies. Even if commonly represented as a cure for unemployment, inflation – as we hope we have demonstrated – can be at best a temporary relief, which instead produces even more unemployment at the peak of its expansion. Furthermore, inflation poses a serious threat to liberal democracies by awakening the desire for more government control.

While Hayek proposed a system of competing currencies as a potential way to fight inflation tendencies, the return to balanced budgets – for a gradual spending cut – remains the best path for keeping national economies on the way toward a sound and prosperous future.

APPENDIX 1: What really happened in the 1970s in the UK?

by John Hearn

In the 1960s, the advisers to government on macroeconomic policy were almost exclusively Keynesian economists. They were relatively pleased that they had more or less achieved their full employment target but were also frustrated by the fact that they felt they could do more to promote real growth in the economy.

As they saw it, their expansionary monetary and fiscal policies always hit the brick wall of a fixed exchange rate and their GO for expansion became a STOP as both fiscal and monetary policy were held back to maintain the value of the currency. However, this was not always successful and sterling had to be devalued by 14% in 1967.

The Tory government formed in June 1970 was persuaded that fiscal deficits and accommodating monetary policies could be used to not only sustain full employment, but also to encourage the economy to grow faster. The Keynesian economists had diagnosed our comparatively low rate of economic growth as a result of the uncertainty created by a fixation on a fixed exchange rate.

If businesses became used to a year-on-year expansionary set of policies, then they would be prepared to invest and grow the economy, and if the exchange rate come under pressure, then it should be floated and side lined as an economic target. "Adopt our policies" and the Keynesian promise of 5% economic growth year on year will be achieved.

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Unemployment was rising when the conservative government came to power and so yearly budget deficits were used in 1971 onwards to expand aggregate monetary demand. The immediate effect on unemployment was good (the unanticipated inflation effect as Friedman would say) reducing it from above 1m to 600,000.

In contrast the immediate effect on the balance of payments current account was not good as the expansionary policies were sucking in imports and applying pressure to further devalue the currency. In June 1972 the currency was floated (downwards) and the stage was set to continue the fiscal and monetary expansions.

By 1974 unemployment had once again risen above 1 million (in spite of the expansionary policies) and the fiscal deficits continued to grow in 73/74 to £4.2 billion. A new labour government in 1974 aimed to reduce this total but it grew to £8 billion in 74/75 and to £10.5 billion in 75/76.

The expansionary monetary and fiscal policies caused inflation to rise from 7.1% in 1972 to 24.9% in 1975 (a monetarist interpretation of the cause of inflation) and by April 1976 the U.K. had to go cap in hand to the IMF for a loan to support our dwindling foreign exchange reserves. This was offered on the condition that we

reduced our borrowing requirement by half from £10.5 billion to £5.5 billion over two years and kept within the constraints imposed, by the IMF for domestic credit expansion. The UK government complied and things started to improve, but as soon as the IMF removed the shackles and election frenzy returned, things began to unravel.

So what are the significant points?

- Keynesian demand management does not facilitate growth, in fact the very opposite, as the 5% yearly target for the U.K. turned out to be 0.6% p.a.
- Unemployment will not fall and will probably rise as soon as expansionary polices and inflation are anticipated.
- James Callaghan got it right when he said, under direction from the IMF, on the BBC in 1976 "We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists, and in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy followed by a higher level of unemployment as the next step"
- The Phillips Curve and Automatic stabilisers are Keynesian myths not supported by fact.
- Reducing the budget deficit by 50% caused things to improve, at least until another frenzy of overspending occurred in 79/80 and 80/81.
- Floating the exchange rate in June 1972 exposed the weakness of the Keynesian argument.
- What happened to the UK economy from 1970-1976 showed the really damaging side of Keynesian economics.
- Unfortunately, these exact same policies were introduced again in 2009. In 1976 the IMF could tell us to stop, but now all G20 members are complicit so who is left to clear up the mess?

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