Testimony before the Pennsylvania House Majority Policy Committee on "What Causes Inflation?"

Shawn Ritenour
Professor of Economics
Grove City College

I thank the Committee for giving me the opportunity to shed light on the nature of inflation. At the outset, it is important to note that inflation is the culmination of a complex process and if we do not understand how we got to where we are today, we run the risk of enacting policy which will make things even worse. Much confusion about inflation exists because of ambiguity concerning its definition. During the twentieth century, governments, journalists, economists, and the public began defining inflation as a "process of continuously rising prices." Before that, however, inflation was more commonly understood as an increase in the quantity of money held by the public.

This switch in focus from an increase in the quantity of money to an increase in the level of overall prices, is monumental, because it can distract us into focusing on a symptom (rising prices) rather than on the root cause (increases in the quantity of money). For our purposes, I think it helpful to operate with two different terms: monetary inflation on the one hand and price inflation on the other. It is monetary inflation that causes the price inflation that we see all around us at the present time. Hyperinflation is a situation in which there is very high and typically accelerating price inflation. Stagflation, a term popularized in the 1970s, is a situation in which we experience both price inflation and recession, usually accompanied by higher unemployment. Both situations will be discussed more later.

Before that, however, we need to consider the process of inflation and how it impacts our economic well-being. Perhaps the most obvious consequence of monetary inflation is that it decreases our money's purchasing power. The purchasing power of money is whatever can be bought with the monetary unit—in our case the dollar. If the price of a post card is fifty cents, then a dollar could purchase two postcards. If the price of a used car is $6,000, then a dollar could purchase 1/6,000th of a car. Note that the

purchasing power of money is not determined merely by the price of one good, but by a large set of prices for a multitude of goods, because all goods are traded for money.

Now, suppose that the prices of all goods double, so the postcard now costs $1 and the car costs $12,000. It is apparent that the purchasing power of money will be cut in half. A dollar could now buy only one postcard or 1/12,000th of a car. In other words, there is an inverse relationship between the level of overall prices and the purchasing power of money. When prices increase, the purchasing power of money decreases.

With that background, we are now able to examine the relationship between monetary inflation, price inflation, and the purchasing power of money. When the Federal Reserve increases the money supply, people will be holding more money in general than they desire to hold at the prevailing level of overall prices. In other words, they experience an excess supply of money, which is an easy problem for people to solve.

They simply increase their spending. Households spend more on consumer goods, increasing demand for them. This increased demand results in higher prices for them, as they are bid up by more eager buyers. Likewise, businesses spend more on land, labor, and capital goods, so the demand for factors of production increases in their various markets. Increased demand for factors of production will cause their prices to increase. In short, the level of overall prices will be higher, and the purchasing power of the dollar will fall.

Note that this process does not generally benefit society. If everyone's cash balances increase by thirty percent, but prices also increase by thirty percent, no one is really any better off. Increases in the quantity of money do not spontaneously create more land, labor, or capital goods, therefore it does not result in more consumer goods either. It merely results in more money being spent on the same amount of goods at higher prices.

However, while there is no general social benefit from inflation, we should recognize that *some* people do benefit at the expense of others. Newly created money does not enter the economy all at once evenly in everyone's bank account. The money first appears in the reserves of a small group of preferred financial institutions, and they lend it out to various borrowers. They are the early recipients of the new money, and they can increase their spending *before* overall prices have risen. They are the ones who benefit from inflation. As the money passes from bank to business to employee to other

businesses, overall prices begin to rise, until for some people, the new money they receive is just enough to offset the higher prices. These people are no better or worse off. There are those, however, who get some of the new money so late in the process that their increase in income is not enough to offset the generally higher prices. And finally, there are some who live on fixed incomes who do not see a dime of the new money but must pay higher prices all the same. These last two groups of people are harmed by the process of inflation. So, while there is no general social benefit from monetary inflation, some citizens do benefit at the expense of others.

This mechanism by which new money enters the economy also is the root of the business cycle which always culminates in recession. When the Federal Reserve injects liquidity into the financial system, it does so by expanding credit, making it possible for banks to offer artificially lower market interest rates. Businesses acquire new money at the lower rates and their entrepreneurial ambitions expand, which results in an economic boom. New businesses are started, using the new money to buy land, labor, and capital goods. Wages increase and happy days appear to be here again. Alas, these new projects appear profitable only because market interest rates are pushed artificially low.

Unfortunately, the new structure of production does not reflect voluntary saving patterns. Investors are led to make investments as if more real savings are available, when in fact they are not. Unless even more new money is again injected into the system, market interest rates will return to their original higher levels and many of the newly begun projects will prove to be unprofitable. These investments will be liquidated. Production contracts and unemployment increases. This inflationary boom-bust cycle is the setting for stagflation: a period of price inflation and stagnant growth.

As mentioned earlier, hyper-inflation is very high and accelerating price inflation. It often happens after a prolonged stretch of monetary inflation and is encouraged by a change in expectations by a critical mass of citizens.

If people come to expect overall prices to be significantly higher in the future than they are now, they have increased incentive to buy goods in the present, rather than wait to buy them after the purchasing power of their money has fallen. This change in psychology further increases present spending, driving up overall prices even faster.

If the central bank responds to such a circumstance by increasing the money supply even more, overall prices will increase at such a rate, that the purchasing power of money will collapse entirely as happened in the Weimar Republic in Germany in the 1920s and in Zimbabwe in the 2000s. We are not there yet, and we do not want to get even close.

The cause of all price inflation, stagflation, and hyperinflation is monetary inflation created by the central bank. Certain policies, such as increasing regulation, shutting down supply chains, and government stimulus funded by new money merely aggravate and effect the specific form of price inflation.

I am happy to answer any questions you may have.