Inflation Is a "Phantom Menace"? It Just Ain't So!

BY GENE CALLAHAN

Princeton University economist Paul Krugman, in his *New York Times* column of June 16, argues that the current fears about an increase in the U.S. inflation rate actually pose a more serious threat to the American economy than rising prices.

As he puts it: "I'm worried too—but not about recent price increases. What worries me, instead, is the Fed's overreaction to those increases. When it comes to inflation, the main thing we have to fear is fear itself."

Krugman acknowledges that there has been a general rise in prices of late, but says, "[T]he real issue is whether there's a serious risk that inflation will become embedded in the economy." He continues: "The classic example of embedded inflation is the wage-price spiral . . . of the 1970's. Back then, whenever wage contracts came up for renewal, workers demanded big raises, both to catch up with past inflation and to offset expected future inflation. And whenever companies changed their prices, they raised them by a lot, both to catch up with past wage increases and to offset expected future increases."

Krugman fails to explain how employers were able to *pay* ever-higher wages to their workers without going broke, or how consumers could afford to offer more and more money for the goods they wanted. Almost everyone would like to be able to charge a steadily higher price for whatever he offers on the market. If one person is able to do so while most others cannot, the higher price will make him genuinely better off, as it enables him to claim a larger share of total economic output than he previously could. But it is clearly impossible for *all* market participants to increase the relative size of their "cut of the pie" at the same time. (Of course, in a growing economy, the pie itself is getting bigger, so successive slices that are proportionally identical still will grow absolutely larger over time.)

If prices are rising across the entire economy, it usually means that an increase in the supply of money is reducing its value relative to other goods. It is true that this process will enrich those whose wealth is concentrated in stocks of commodities rather than in cash, but that happens at the expense of those holding the bulk of their wealth in bank accounts, money market funds, and fixed-income pensions. Inflation redistributes wealth toward people who, by foresight or by luck, have anticipated rising prices, but it cannot create prosperity—only saving and the effort to produce what other people will appreciate can do that.

Krugman tacitly acknowledges that the real source of inflation is the treasury's printing press, not abstract "pressures" or "spirals," when he notes, "The Fed eventually brought the inflation of the 1970's under control" by raising interest rates to slow the growth of the money supply. If the source of that inflation hadn't been the flood of new money pouring from the monetary authorities in the early '70s, then how could choking off that flow have alleviated the problem? Sellers, no doubt, would have *liked* to continue to get steadily higher prices for their offerings, but when the Fed stopped inflating the money supply, they were no longer able to do so.

Krugman contends there is little chance of a "wage-price spiral" setting off today, because wages aren't increasing much. That leads him to ask: "But if wage pressures are so moderate, where's the inflation coming from? The answer is soaring oil and commodity prices."

Once again, money is notably absent from Krugman's

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story. If the amount of money in circulation hasn't increased, then a rise in the price of, say, oil, gold, or wheat must be offset by a decline in the price of various other goods, making for a relatively stable purchasing power for the dollar. People can only spend more on some things without spending less on others when there is more money around than there was before the price increases. (Since Krugman makes no claim that rising commodity prices have had an impact on the "velocity" of money, I see no need to introduce that complication in responding to his argument.)

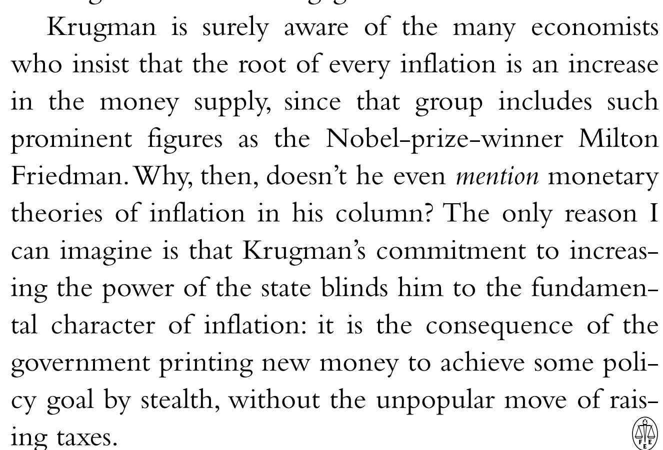
Krugman even tries to get us to make friends with inflation: "And bear in mind that many economists . . . have said that a little bit of inflation… is actually good for the economy." Sure, and many economists once claimed that socialism could provide a higher standard of living for the common man than capitalism could. Those temporarily mistaking a general rise in prices for increased demand for their product or service may briefly be spurred into increasing their output, creating the appearance of a booming economy. But since the increase in production is prompted by a misunderstanding of the real economic situation, it inevitably will result in the misuse of scarce resources. Once it becomes apparent that consumers were not really expressing a greater demand for the goods whose prices were rising, but were only bidding more because more dollars were available than before, then many producers will come to regret their decisions to increase output.

The spurt of business activity generated by "a little bit of inflation" is closely analogous to the spurt of physical activity following the ingestion of "a little bit of speed." Both seem to create positive results in the short run but prove to be unsustainable and costly in the long run. Keynes attempted to dismiss such objections to his own inflationary prescriptions by noting "in the long run, we are all dead." However, in the case of an inflationary boom, the "long run" is short enough that most of those who were present for the opening act will still be around for the denouement.

Could Be a Problem

To his credit, Krugman does admit that he "can think of ways in which inflation could become a problem." But that mental exercise shouldn't tax a prize-winning economist very much. For instance, it does not require an esoteric appreciation of some arcane economic theory to conceive that inflation could become a problem by tearing apart the very fabric of social cooperation in a nation, as it did, say, in Germany in the 1920s, Argentina in the '70s and '80s, or Hungary at the close of World War II. It might also have occurred to Krugman that even "moderate" inflation is problematic, since it distorts the price system, rewarding some people not for their productivity but because they correctly anticipated rising prices, while penalizing others whose only sin was to be holding too much cash during an inflationary period.

Krugman declares that he is far less concerned by the specter of inflation than he is about other possible economic troubles, such as "a rapidly deflating housing bubble." But what pumped up the housing bubble in the first place? It is simply a manifestation of the easy money that the Fed previously supplied to lenders. The aim of that policy was to maintain consumers' enthusiasm for spending, an enthusiasm generated by the steady and strong rise in the price of their houses, thus enabling homeowners to upgrade their lifestyles through refinancing and second mortgages.



Krugman is surely aware of the many economists who insist that the root of every inflation is an increase in the money supply, since that group includes such prominent figures as the Nobel-prize-winner Milton Friedman. Why, then, doesn't he even *mention* monetary theories of inflation in his column? The only reason I can imagine is that Krugman's commitment to increasing the power of the state blinds him to the fundamental character of inflation: it is the consequence of the government printing new money to achieve some policy goal by stealth, without the unpopular move of raising taxes.