INTERNAL FACTORS CAUSING AND PROPAGATING INFLATION: I

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I. INTRODUCTION

Many different factors and policies have been made responsible for inflation. Let me mention a few. Some say aggregate demand rising faster than aggregate supply ‘pulls up’ prices and wages. The rise in demand in turn may be due to a government deficit (government inflation) or to an expansion of bank credit for private investment (credit expansion) or rising demand from abroad (imported inflation) or an increase in gold production (gold inflation). Others say prices are being ‘pushed up’ by wage increases forced upon the economy by labour unions under threat of strike; or costs may be raised by business monopolies (administered-price inflation). To these positive factors can be added negative ones — for example, the failure of over-all output to grow, or of savings to stay on their ‘normal’ level — factors for which, in turn, different causes can be found. It is not difficult to think of conditions under which one or the other of these hypotheses would be valid, or to provide actual examples of several of them from recent economic history.

But let me try to give a somewhat more orderly and systematic analysis of the causal mechanism. Let us start from the basic fact that there is no record in the economic history of the whole world, anywhere or at any time, of a serious and prolonged inflation which has not been accompanied and made possible, if not caused, by a large increase in the quantity of money. This generalization holds of developed as well as under-developed countries, of capitalist, pre-capitalist and even centrally planned economies. It is true that the velocity of circulation of money changes. It has a cyclical pattern,

1 The reader should realise that this is a somewhat abbreviated version of a paper read in 1959. A fuller, more up-to-date treatment will be found in my pamphlet, Inflation: Its Causes and Cures, American Enterprise Association, 2nd revised edition, Washington, 1961.
usually going up during prosperity phases of the cycle and falling during depressions. During the Great Depression of the 1930s the velocity of circulation of money (the ratio of money income to the money stock) fell, and during the war it reached an abnormally low level. Since the end of the war it has gradually returned to higher levels. It also seems to have, at least in the U.S.A., a slight downward secular trend; that is, the economy has become more ‘liquid’. The ratio of the money stock to national income has been higher during the last twenty or thirty years than it was early in the century, and much larger than in the 1870s or 1880s. But except in periods of hyper-inflation (which could not develop without a sharp and sustained rise in the quantity of money) a rise in velocity by itself has never caused or substantially intensified serious inflationary trouble.1

It follows that in every inflation, money is a causal factor, either active or permissive, and none of the factors and policies mentioned above can produce serious inflation unless they cause or induce or are accompanied by, an increase in the quantity of money. Sometimes the connection between any one of these factors and the quantity of money is direct and non-controversial; in other cases it is indirect and subtle. When, in the advanced industrial countries in times of war, or in many under-developed countries even in times of peace, the government has a large deficit which is financed directly or indirectly by the Central Bank — the mechanism of inflation is clear. If in peace-time the Central Bank is obliged to hold the interest rate down by pegging government securities at low yields (as the Federal Reserve System was forced to do before it regained independence through ‘the accord’ with the Treasury in 1951), it becomes an engine of inflation. If, in a world-wide inflation, any single country does not wish to appreciate its currency in terms of international money, it must undergo inflation.2

1 It should be understood, when judging this statement, that I define inflation as a rise in prices and not as an increase in \(MV\). During depressions, \(V\) falls and the economy becomes more liquid. Recovery from a depression can therefore be financed to some extent by a more intensive utilization of the existing money stocks. The Great Depression and the ensuing war produced an unusual accumulation of idle funds; hence the post-war expansion could be financed to an unusual extent by a more active use of the existing stock of money. But these facts do not invalidate the statement in the text, for the reason that in such circumstances the increase in velocity is matched by an increase in output. I do not claim that there must be an exact parallelism between the rise in output and the increase in \(V\), so that any rise in prices must be attributed to an increase in \(M\). The increase in \(V\) may exceed, or fall short of, the rise in output. What I say is that a prolonged and serious inflation (price rise) has never been caused by an increase in velocity.

2 It should be observed, however, that even a single small country, if it lets its currency go up in terms of foreign currencies, cannot be forced to share in an international inflationary orgy. Nor is there any necessity or even probability that it will hurt itself by staying out.