INFLATION
DIAGNOSIS AND THERAPY

BY

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1 INTRODUCTION

The view that inflation is something the Western world will have to learn to live with is gradually being replaced by the recognition that, on the contrary, the rampant inflationary process – the 'cancer of inflation' as Walter W. Heller¹ has labelled it – represents a lethal threat to our society. In what follows I shall attempt to analyse the circumstances and the forces responsible for the occurrence of the disease we call inflation and to indicate the direction in which to look for a permanent cure.

Inflation may be defined as a persistent decline in the value of money as a medium of exchange, the decline being reflected in a rise of the general price level. Dependent on the pace of the decline, inflation may be described as creeping, marching or galloping.²

In deciding which prices should be taken into account and how they should be weighted in order to assess the movement in the general level of prices a certain measure of arbitrariness is unavoidable. A yardstick which readily suggests itself is the implicit price deflator of national expenditure; it is thrown up by the national accounts and its movements are very similar to those in the 'price' of real national income. In principle it should be adjusted for changes in the burden of indirect taxes, because their effect on prices cannot be regarded as expressing a change in the value of money as a medium of exchange.

Naturally, inflation as defined above can only occur in a money-using economy. It is meaningful, therefore, to regard inflation first of all as a monetary phenomenon and to discuss its monetary aspects in greater detail.

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2 See the introductory article in this special issue of De Economist by Dr. J. Zijlstra.
2 SCOPE FOR DISTURBANCES INHERENT IN THE USE OF MONEY AS A MEDIUM OF EXCHANGE

A society that makes use of money derives immeasurable benefits from its use. The benefits primarily concern the organization and the settlement of exchange. With money as a unit of account, the $\frac{1}{2}n(n - 1)$ exchange ratios that exist between $n$ goods may be expressed in terms of no more than $n$ market quotations (prices). With money as a medium of exchange, i.e. as a means of payment, the exchanges may be settled by the actual use of money as an intermediary; instead of having to take place in a cumbersome labyrinth of (multilateral) barter transactions with prohibitive costs of information and settlement, the exchanges can be reduced in a simple and straightforward manner to transactions in $n$ markets. Besides these primary functions of unit of account and means of payment there are the derived ones – which may be undermined by the decline in the value of money – of standard for deferred payments (the unit in which claims and liabilities can be expressed) and of store of wealth (a means to store up wealth to have it immediately available for exchange without costs or loss of value). The fact that in addition to its value as a medium of exchange, money is useful to its holder in its own right is illustrated by the holder’s willingness to forgo interest receipts in order to be able to maintain (non-interest-bearing) cash balances (marginal liquidity preference).

Although the whole system of exchanges thus benefits immeasurably from the use of money, its very use at the same time introduces opportunities for the occurrence of disturbances that by definition are impossible in a barter economy.

Walras’ well-known theorem states that in a barter economy – which does not necessarily exclude the possibility of a certain commodity being regarded as unit of account – the sum total of ex ante excess demand and of ex ante deficiency of demand on the various commodity markets must be zero. The theorem may easily be extended to include the labour market and the ‘capital’ market, i.e. the market where present goods are exchanged for claims on goods to be delivered in the future. The main characteristic of a barter economy is that any increase in the demand for goods, labour or debt instruments involves a lower demand for (or a greater supply of) other goods, labour or debt instruments, and vice versa. Barter transactions thus being both simultaneous and complete implies that all markets can continually be brought into equilibrium by an adjustment process which, by means of small changes in the quantities actually exchanged and in the terms of trade, eliminates all ex ante...

3 The resulting rate of exchange is the ‘own rate of interest’ of the goods concerned.