13
The Social Consequences of Inflation*

Explanations of inflation: why is it so?

Following Keynes's analysis in *The General Theory* of the causes of prolonged recessions, economists (including Keynes himself in *How to Pay for the War*) have adapted his analysis in order to tackle the puzzle of inflation. Just as recessions were seen to result from the inability of a decentralised capitalist economy automatically to provide sufficient overall demands with which to absorb the total supplies of goods and services that would be forthcoming *if* the potential workforces and existing stocks of capital goods were fully employed at each point in time, so inflation was seen to be due to an excess of total demands in real terms over available supplies of goods and service *when* the potential workforces and existing stocks of capital goods *were* fully employed. The resulting 'inflationary gap', the tendency for planned investment expenditure to exceed full employment saving, generated tendencies for stocks of goods to be run down, queues to form, order books to lengthen and prices to rise. (The exact mixture of these ingredients depended upon the nature of the market structures of the economy concerned.)

The theory did not predict the *rate* at which prices rose, only that they would tend to rise. It did suggest that rising prices themselves could cure an inflationary situation *only* if their impact on planned real expenditures was to reduce them. Unlike the market for a single good, where an initial imbalance between demand and supply may be removed by a rise in the price of the good, an imbalance between total

* Originally published in the *Australian Accountant*, October 1974, 520–8.

G.C. Harcourt, *Selected Essays on Economic Policy*
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demands and supplies is not necessarily removed by rises in the general price level. For the other side of overall rising prices is rising money incomes of the same amount (abstracting from overseas transactions and the government for the moment), so that the capacity to buy at the higher price levels is not impaired in real terms. (In the market for an individual good, it is reasonable to suppose that the incomes of its purchasers are in the main independent of those of its suppliers, a supposition that is patently false for the economy as a whole.) It *might* be that, in an inflationary situation, there would be a tendency for prices to rise faster than money-wages. Real income then would be redistributed by the inflationary process from a class which tends to spend much of its income, both on average and at the margin (the wage-earners), to one which does not (the profit-receivers), so that the overall level of planned spending in real terms on consumption goods could be reduced. If, also, the level of planned investment in real terms is not raised by the inflationary situation, there may be a level of prices overall that would be consistent with 'full employment without inflation'. But there is no guarantee that this will be achieved – money-wages may not, for example, continue to lag behind prices – and, in any event, as it is the fall in the level of planned spending that is the key, it may be better consciously to bring this about rather than to depend on (and wait for) 'automatic' market forces to do so. Especially is this so in an open economy trading with the rest of the world; in this case the general price level that is consistent with full employment without inflation at home may be associated with a level of demand for imports which *vis-à-vis* export earnings and desired borrowing from, or lending abroad may imply serious balance of payments difficulties. Implicit in this discussion is the assumption of a flexible money supply. Otherwise, rising prices may have such an impact on rates of interest through the rise in the demand for money that expenditures in real terms are sooner or later choked off by higher rates of interest and the accompanying lower supplies of funds.

Also implicit in the preceding discussion is an assumption about the nature of the markets for individual commodities and productive services, namely, that they are competitive ones in which each individual, whether supplying or demanding a good or a service, is a price-taker. That is to say, prices are set by the automatic market forces and individuals lack discretionary power over the prices that they receive or pay for products and services. Clearly this is an unreal