Inflation: Disease or Symptom of Good Health?

Part of the difficulty in devising an effective policy for stable economic growth is failure to recognise the true nature of the problem of price inflation.

The Economy and the Dirty Nappy

It may sound ridiculous: but inflation, so far from being a disease, is often a symptom of good health. It is the economic equivalent of a baby’s dirty nappy. A dirty nappy is the natural by-product of a normal healthy baby. Yet, if nothing is done, it can become a serious health hazard: it will breed infection and, in extreme cases, may even result in death.

Economies also dirty their nappies, particularly during periods of rapid technological progress (like the transition from agriculture to manufacturing and from manufacturing to services) which cannot be accomplished without fairly drastic social change. Conflict may arise over relative shares as badly placed individuals (or nations) seek to “catch up” and well placed individuals (or nations) seek to “maintain differentials”; and it may manifest itself in the desire of the community as a whole to consume more than it produces. In a free society, the result is a more or less rapid rise in the general level of prices; and the mess in the nappy is called “inflation”.

Conventional economic policy is based on the mistaken assumption that inflation is a disease and that the object is to prevent it from happening. It seems to be taken for granted that intervention by the

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1The following parable is a repetition of an analogy used in Economics Through the Looking-Glass [Rayman (1998) chapter 4].
government or some other authority is necessary to prevent market forces from operating freely. During the 1960s, when the debate was at its height, the controversy was over the type of intervention to be employed.

The “monetarists”, after painstaking empirical research, had discovered a close correlation between the quantity of food (money) fed in at one end of the baby and the amount of mess (inflation) expelled at the other. With impeccable logic, they recommended control of the baby’s food supply by careful monitoring of significant food aggregates (which went under esoteric labels like $F_1$, $F_2$, and $F_3$).

Their opponents disagreed. Cutting down baby’s food supply had undesirable side-effects: it cut down baby’s growth. Their alternative was not to stop feeding the baby but to prevent the unpleasant consequences from emerging by clamping its legs together with controls over prices and incomes. Although this approach avoided starving the baby, it was not without its drawbacks. By restricting the baby’s movement, it hampered its development. Worse still, it was only a temporary expedient. The nappy could be kept clean for a time, but, when the internal pressure could no longer be contained, the consequences were liable to be explosive.

Nappy changing was naturally rejected out of hand by serious economists as a superficial expedient which merely treated the symptoms and did nothing to remove the cause. The debate could therefore be continued over fundamental issues – namely, which end of the baby should be blocked up.

The New Fundamentalist consensus has therefore resulted in a rather unconvincing compromise. Intervention is effected through regulation of interest rates rather than control over the money supply. The “single-gear” fallacy plays a crucial role – as a fig-leaf. It provides those who are ostensibly committed to market freedom with an excuse to interfere in money markets on the grounds that the damage to the real economy is only “temporary”.

Conventional economics offers no alternative to this choice of evils. Like a stopped clock, which is right twice every twenty-four hours, single-gear interventionism manages to achieve temporary periods of price stability and full employment. Whether the controls are over the money supply, the rate of interest, or prices and incomes, they do more lasting harm than temporary good. Macroeconomic interventionism almost always succeeds in reducing inflation over relatively short periods. But, because it inhibits growth, it is inevitably detrimental to the long-term development of the economy.