Joe Cobb

THE MYTH OF THE STABLE PRICE LEVEL

INFLATION has become a way of life for most Americans, changing the values they place on saving for the future as opposed to consuming luxury goods today. When all prices are seen as rising, why should you try to save up the cash for some purchase when you might buy it now on credit, and pay just a little bit more over the next several years. In financial circles, the emphasis is no longer on asset management but liability management. Inflation benefits the risk-taking speculator, not the conservative or prudent who dislike financial risks. The average citizen feels the pain, and public opinion polls reflect a demand for a stable price level.

Almost every economist would agree that a stable price level would be a desirable social objective. Some economists would argue that a little bit of inflation is a healthful tonic for a stagnant economy, but rare indeed is the economist who wants to see a declining price level. It is as if any general trend for prices to fall might cause some kind of economic disaster. A Great Crash in the stock market, perhaps, would recur.

The economists, however, who put their faith in a stable price level are *not really practicing economics at* all. They are indulging in politics. Certainly the line between economic policy analysis and political practice is a narrow one, but the difference is clear. An economist might look closely at the indirect economic effects of a government policy and make a professional judgment about the effects of the policy; but when he evaluates them as "good" or "bad"

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he is a mere politician, advocating a government action for reasons of his own.

The Idea Develops and Becomes Fashionable

The idea of a stable price level became fashionable during the early years of this century, after the political debates of the 1870-1910 period. For the first 25 years of this period, there was a slow and steady increase in the purchasing power of gold, followed by a relatively rapid drop in its purchasing power when gold was discovered in South Africa and the Klondike. In addition, the demand for gold increased following the Franco-Prussian war, when Germany adopted the gold standard; and throughout this era, Europe and America enjoyed rapid industrial growth. The heightened demand for capital and labor during this era of international peace and economic expansion had a predictable effect, at the margin, on the demand for money and credit.

There were several interest groups in the United States that demanded an inflationary monetary policy, to supply them with the capital and credit they thought they deserved. Many farmers, for example, unwisely mortgaged their properties at fixed rates of interest, and then saw a period of declining farm prices, lower interest rates, and the bankruptcy of marginal farming enterprises. Agricultural employment, you will recall, was giving way to relatively more productive industrial employment. But the politicians (and the economists) looked for a solution to the complaints of the farmers. There was the Greenback Movement that demanded inflation, and the free silver movement that had a similar program, but coining silver instead of printing paper money was their pet project since the Nevada silver miners were part of the coalition.

The economists came up with the idea that a declining price level is "bad" because debtors have to repay their loans with more valuable units of money than they borrowed. Since a free market adjustment to this situation might require a *negative interest rate,* they said it was impossible. After all, who ever had heard of a loan where you would repay less than you borrowed—even if the units of money themselves increased in value as the years rolled by? This, of course, was pure hidebound prejudice; they forgot that the market always adjusts to changing circumstances.

So the economists, playing the role of politicians, have decided that a stable price level is much better than a declining price level. For many years, also, there were economists like Paul Samuelson and John Maynard Keynes who argued that a little inflation is *better* than a stable price level, because they said it would stimulate employment, growth, and other good things. The stage was set by such politically-motivated economists to launch the Great Inflation of the 1970s.

Productivity and Declining Prices

Economic growth includes, among other things, the increase in capital investment and concomitant increase in the productivity of labor. There is every reason to believe that the free market, without government interference with the money supply, would bring about lower prices over time for various goods and services. The examples of the ballpoint pen or the electronic calculator or the digital wristwatch come immediately to mind. Historically, we find that the increase in productivity occurred in almost every area of production and distribution. Surely no economist would view this as a "bad" development. Yet, they seem to think that a "declining price level" is not good.

Milton Friedman proposes that the government should expand the money supply at a slow and steady rate in order to prevent a declining price level. Some economists couch this argument in terms of increasing the money supply at the long run average rate of the growth in productivity of the economy, but it amounts to the same proposal. Some economists seem to think that the new, government-printed money is necessary for the economic growth itself to occur; others will tell you that it is to accommodate the demands of labor unions for higher wages, which otherwise might cause some unemployment.

No economist, however, who subscribes to the current orthodoxy of macroeconomic theory is willing to endorse a zero-growth policy for the money supply. Some of them will exclaim that this would cause massive unemployment, another Great Depression, bank failures, and so forth. Others will just dismiss the idea with the words, "That's politically unrealistic . . ." without telling you why—or even how they came to possess their expertise in politics, rather than economics.

If declining prices would be the normal pattern under a free market system, the proposal to increase the money supply in order to keep the average level of prices from declining is in truth *a proposal to nationalize part of the increase in productivity.* Since the newly issued money that is supposed to cause just enough upward pressure on prices to keep them from declining is legal tender, just like the old money that already is folded away in people's pockets, the government that prints it is also the first to spend it, and so the government reaps the fruit of other people's labor. Since this "painless tax" is supposed to keep the price level stable, it is assumed that nobody notices. Yet, as we have shown, it is an insidious example of the old "broken window fallacy" because without this new money, prices would fall and everyone would benefit throughout the general society. With the "stable price level" policy, in effect, only the government and its clients can benefit from the growth in productivity.

The Fallacy of the Price Level

The problem of a policy to promote a stable price level is much more flawed, however, than the discussion above would suggest. Economists talk about The Price Level as if it were a concrete, economic phenomenon. At best, however, they are really talking about an index of prices, such as the Consumer Price Index. An index of prices is a statistical sample of various quoted or recorded prices in the economy at any given point in time. Additional samples at later times will tell you if the index has increased or decreased, and this is supposed to inform you about the change in "the price level."

There are two general kinds of price indexes. Since all such indexes are made up of "market baskets" of goods, and since people's purchasing habits change—especially if relative prices change, and they substitute more of a cheaper product for a relatively more expensive one they used to prefer—the price index between two periods of time can either hold the basket of goods constant in Period One and measure its price changes at Period Two, or it can take a basket at Period Two and look back to see what prices were quoted in Period One. The second procedure usually shows a smaller proportionate change. The United States Consumer Price Index is an example of the former. In statistical theory, a very large random sample should be a good measure of the average level of prices in the economy.

The "average level" of prices in the economy, however, is not a very important bit of information (except to journalists). Even the macroeconomists who pretend to place great emphasis on "the price level" have no real use for the information. It shows up in their computer model simulations of the economy as part of their data, but they might just as well have made up the data since their computer models generally fail to predict the direction of the economy or the coming year's index of prices anyway. The price index has as much use to economists as the Dow Jones averages have to the investor: it satisfies a moment's curiosity, but no serious professional would make a decision based on it.

Indeed, for the businessman, the average level of prices is totally irrelevant. What is important for economic decisions is *the relative dif-*

ferences in specific prices. An entrepreneur might want to know about price changes for a certain type of structural steel, to judge whether to buy steel or aluminum to manufacture a product; but the average price of steel or the average price of aluminum would not help him make this decision, much less the average of all prices. Indeed, the specific price of steel might well include a stipulation about delivery date, location f.o.b., and terms of payment. Moreover, in every case the entrepreneur would be looking for future prices, not the prices of last week or last month, since his plans to make use of the steel are future-oriented.

Resources Reallocated

The policy of the government to issue money, in order to keep the price level from falling with the growth in productivity, can be positively destructive to the efficient coordination of plans that Professor F.A. Hayek identifies as the central purpose of the price system. When the government issues new money, somebody always receives it first—whether it appears in the paychecks of civil servants, or as Social Security payments, or as loans to favored companies, such as the Chrysler Corporation, or as bailouts for municipal bonds, as with New York City.

If the new money goes into the chain of production, then some businesses receive funds to bid away resources from others that might have made better use of them. If the money goes first to consumers, then the demand for consumer goods will increase relative to the demand for capital goods and there will develop a relative shortage of capital. There is no way to predict the full range of distortions in the productive process that could result from the artificial creation of new money and credit by the government, in order to promote a "stable price level." Indeed, as we have seen in the past fifteen years, the result of government policies to stimulate the economy by expanding money and credit have produced a raging inflation as well as a serious economic downturn with significant unemployment.

Ideas Have Consequences

The idea of a stable price level may be at the root of our problems with inflation. Since most people seem to believe that a stable price level is the same thing as "zero inflation," this might be surprising. Yet, the conclusion by professional economists that a stable price level is the optimal policy immediately suggests that the government should do something to achieve this policy—since the free market itself would bring about declining prices. Here we observe a group of "experts" endorsing an active government role of intervention. If any citizen might doubt that government intervention into the economic affairs of a nation is good, the solemn, non-political expert will assure him that "it is absolutely necessary."

It is the loss of perspective by the economics profession that is at the root of the problem. The younger economists have been taught that a stable price level is the necessary, optimal policy—rather than a stable money supply. The old professors seem to have forgotten that politics and economics are different fields of expertise, and that economists make bad politicians. An economist who tells the truth is unlikely to be popular, since he has to tell his supplicants that there is no such thing as a free lunch; and an economist who tries to judge what may or may not be politically feasible will end up giving second-best advice, if not worse.

Economic concepts, such as "the price level" and even "the money supply," are dangerous to play with loosely because it is so easy to lose sight of the market process that gives rise to such generalizations. Even a policy objective of "a stable money supply" would be misleading, because it too relies upon statistical measures of money—and omits the many significant substitutes. The only economic policy that has ever "worked" the way politicians and economists expected was the policy of laissez faire, which changed the course of history and lifted mankind out of the dark ages.

The Free Market

IDEAS ON LIBERTY

The free market, by decentralizing the decision-making process, by rewarding the successful predictors and eliminating (or at least restricting the economic power of) the inefficient forecasters, and by providing a whole complex of markets, including specialized markets of valuable information of many kinds, *is perhaps the greatest engine of economic continuity ever developed by men.* That continuity is its genius. It is a continuity based, ultimately, on its flexibility in pricing its scarce economic resources. To destroy that flexibility is to invite disaster.

The myth of the stable price level has captured the minds of the inflationists, who seek to impose price and wage controls in order to reduce the visibility of the effects of monetary expansion. On the other hand, stable prices have appeared as economic nirvana to conservatives who have thought it important to oppose *price* inflation. They have mistaken a tactical slogan—stable prices—for the strategic goal. They have lost sight of the true requirement of a free market, namely, flexible prices.

GARY NORTH, *An Introduction to Christian Economics*

Henry Hazlitt

The Sphere of Government

Nineteenth Century Theories: 3. *Thomas H. Huxley*

THOMAS HENRY HUXLEY was primarily a biologist, second only in eminence in the nineteenth century to Charles Darwin, whose theories of evolution he defended with such pertinacity and effectiveness that he was popularly known as "Darwin's bulldog." He also wrote on a wide range of other subjects, including scientific method, philosophy, education, religion (he called himself an "agnostic," and invented the term)—and politics.

His views on the proper sphere of government are principally set forth in two essays: "Administrative Nihilism" (1871), and "Government: Anarchy or Regimentation?" (1890).

In the first of these essays, he begins with an unsympathetic description of the opponents of wide-ranging state powers:

"To these opponents, the Education Act is only one of a number of pieces of legislation to which they object on principle; and they include under like condemnation the Vaccination Act, the Contagious Diseases Act, and all other sanitary Acts; all attempts on the part of the State to prevent adulteration, or to regulate injurious trades; all legislative interference with anything that bears directly or indirectly on commerce, such as shipping, harbors, railways, roads, cab-fares, and the carriage of letters; and all attempts to promote the spread of knowledge by the establishment of teaching bodies.... According to their views, not a shilling of public money must be bestowed upon a public park or plea-

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Henry Hazlitt, noted economist, author, editor, reviewer and columnist, here continues a series of nineteenth century theories on the sphere of government.