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Inflation: Common Fallacies And Real Issues

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PREFACE (to the Second edition)

This paper was first published in June 1977. It is heartening to note that a few months after it had been distributed quite widely (among alumni and the business community), the few hundred remaining copies were all requested and it became effectively "out of print". A number of requests for copies went unsatisfied. It was thought, therefore, that a reissue would be appropriate. In the process, I have availed myself of the opportunity to make some changes.

In the short time since it first appeared, this paper has stimulated considerable discussion and some controversy*. I have benefitted, by being forced to rethink certain issues, and by the discussions to which I was party. As a result I have made numerous stylistic modifications. In addition, I have added a reference to the important work of F.A. Hayek on the political dimensions of inflation.

As with the first paper I am indebted to the participants of an Economics Workshop at the University of the Witwatersrand for valuable comments on earlier drafts and to Karl Mittermaier and Greg Suddards who contributed generously with their time to read and discuss various points in depth. I am also grateful to Professor D.W. Goedhuys for his helpful comments and editorial assistance.

* See the discussion in the South African Journal of Economics, March 1978.

EXPLANATORY NOTES

This paper contains a minimum of technical symbols that may frighten or confuse the reader without some explanation. The following brief notes should be referred to for clarification.

The equation;

$$M = kPQ = kY$$

is used. This is famous in economic literature as the Cambridge cash balance equation. It relates the money supply, M , (notes and coins and demand deposits) to prices in general, P , and quantities of goods and services in general, Q . $Y = PQ$ is often called *national income* and is the sum total of all individual expenditures in any given period. M is expressed as a proportion k of PQ .

2. Therefore, if M changes either k or Y or both must change and this is the subject of this paper. In a modern economy both M and Y are growing and, therefore, the equation must be expressed in *growth* terms.

It can be shown that this will give

$$gM = gk + gP + gQ$$

where g is understood to mean "percentage rate of growth".

gM = the rate of growth of money
 gP = the rate of inflation
 gQ = the rate of growth of the output of the economy
 gk = the change in the speed at which money circulates. (If gk goes down, money circulates faster).

INTRODUCTION

Now that inflation, a world wide phenomenon, has come to be perceived as a serious problem by economists and others alike, consideration of its causes and effects is a favourite topic. The rate of increase of one or other price index is now a matter of national concern. With the widening area of the debate a number of issues seem to have become confused and, what appears to be an already difficult subject, has been rendered almost totally unintelligible. Indeed, to those interested in a dispassionate, careful and articulate approach to the causes and consequences of the inflationary process, it is a continual source of disappointment, if not trauma, to find (supposedly well trained) economists leading the march into confusion and illusion.

This paper is ambitious in that it attempts to state clearly what appear (to me at least) to be the simple theoretical ingredients necessary for an understanding of inflation. It is, by contrast, modest in that it does not state anything new, but attempts rather to highlight crucial issues and to separate what should be from what should not be legitimate issues for debate. The motivation for this attempt is the belief that confused thinking has confounded terminological and conceptual questions with substantive issues.

What follows, therefore, attempts first to build a simple theoretical construct, second to examine some common arguments about inflation within the construct, and third, to point to some areas of legitimate debate and ongoing research.

2. WHAT IS INFLATION

Inflation is usually understood to refer to a situation of *persistent* increases of *prices in general*¹. The importance of the italicized words cannot be over-emphasized. An increase in one, or even in all, prices is not inflation. An increase in one price, others remaining the same, is a change in *relative* prices. An increase in all prices is an increase in the *absolute* price level. If it is not persistent it may simply rank as an increase in the price level once and for all.

¹Strictly speaking, as will be clear from the subsequent discussion, this refers to *price* inflation. A situation of general excess demand is inflationary whether or not it is reflected in a rise of money prices. It may be argued that all such situations must, in a market economy, *eventually* result in price increases. For a formal treatment of the problem of defining and measuring inflation, see my "On the Definition and Measurement of Inflation", South African Journal of Economics", 45(3) Sept. 1977 p.g 289-293).

Obviously this definition admits of some element of arbitrariness. How long is persistent? How general is general? Nevertheless it is a widely accepted definition and is perhaps no more arbitrary than other related concepts in economics, for example, involuntary unemployment.

3. THE CAUSES OF INFLATION

Given that inflation is a situation of persistently rising prices in general, its causes may be found simply in those forces which cause prices in general to rise. Some economists characterise these as those forces which lead to an 'inflationary gap', a term whose frequency of use appears to have diminished in recent years. A more common way of characterising an inflationary situation is one in which there is general state (or tendency) of excess demand. In simple terms, whenever the demand for output in general (the counterpart of prices in general) exceeds the supply of output in general at a particular price level, there will be a tendency for the price level (prices in general) to rise. A situation of actual or emerging persistent excess demand will be accompanied, in a market economy, by price inflation.

It is important to note that a policy designed to inhibit the rise in the price level (by an incomes policy, an inflation manifesto or some similar policy) is attacking the symptoms of the disease rather than its causes. If a state of excess demand remains while price rises are inhibited an inflationary situation none-the-less exists. Indeed, it is a situation of suppressed rather than open inflation and one which is potentially more destructive for reasons which will emerge later.

The discussion may be slightly formalized. At any point of time for a given market economy the following equation will apply, given the appropriate definitions.

$$(1) M = kPQ = kY$$

where

M = the supply of money (conventionally defined)

P = a "suitable" price index taken to represent the price level

$Q = \frac{Y}{P}$ = real income (obtained from money income (Y) deflated by the price level)

and $k = \frac{M}{Y}$

k can also be written $\frac{(M/P)}{Q}$, and interpreted as the proportion of *real* income that is kept at the particular point in time in *real* balances. (On the assumption that the supply of real balances is equal to the demand for them — any difference implying a rapid adjustment of the price level — k is sometimes interpreted as the demand for real balances as a proportion of real income). For clarification see the explanatory notes to this paper. If money and income are growing, it is apparent that inflation will occur if and only if

$$gM > (gk + gQ) \text{ or } (gM - gQ) > gk$$

where g means ‘proportional rate of growth of’

That is, whenever money grows so much faster than production that it is not matched by an increase in the demand for it, inflation will occur. It means the demand for production is greater than the supply. There is no escape from this conclusion. It seems reasonable, therefore, that any discussion about the causes of inflation should proceed in terms of the determinants of gQ , gM and, therefore, gk . And certainly it is about this that legitimate differences of opinion can arise.

What will be seen to be a matter of confusion rather than opinion though, are statements that fail to distinguish between relative price changes and absolute price changes. It will be seen that only the latter can affect the rate of inflation as it has been defined here. Relative price changes are usually understood to imply changes in the price structure. This could occur at a constant level of overall real income and expenditure. In terms of our framework this implies that Y , and therefore M/k , are constant. An increase in expenditure on one commodity would be offset by a decrease in expenditure elsewhere in the economy. To be sure, relative price changes may affect the level or rate of growth of real income which in turn may affect the price level or its rate of change. This is to say that relative price changes may induce absolute price changes. But it is only the latter that *may* (and certainly may not) be associated with inflation. Only if the absolute price change is persistent does it affect the *rate of change* of the price level, that is, the rate of inflation.

If there are no absolute price changes then, by definition, $g(M/kQ)$ and gP are unaffected. Individual prices and quantities may change but the changes are, by definition of pure relative price changes, offsetting.

In reality, gP (the instantaneous rate of inflation) is never observed. Instead the change in price indices is observed over a discrete period of time. This implies that inflation may be inaccurately measured. A Laspeyres index gives too much weight to relatively high price items whose share tends to decline and a Paasche index too little weight to those items.

It is the former that is often used in discussion about inflation and so a purely relative price change may be incorrectly seen as inflationary. Even Fisher’s “ideal” price index may be inaccurate. However, if both Laspeyres and Paasche indexes show an increase one can be sure that an absolute price increase has occurred at a rate somewhere in between the two.

The sample of “typical fallacies” enumerated below is mainly a result of the emphasized confusion of relative and absolute price effects. They are fallacious in the sense that they associate a relative price change with inflation without pointing to the implicitly assumed (or implied) absolute price change that would be necessary (but not sufficient) for an inflationary effect. It is in this context that I maintain that relative price changes can never, in themselves, be inflationary. Failure to pay attention to this may indeed divert attention away from the political and social factors that are associated with the inflationary process.

4. SOME COMMON FALLACIES

With only this much by way of theoretical structure it is possible to dispose of some fallacious arguments concerning the causes of inflation. A sampling follows.

“Wage increases in excess of productivity are inflationary”.

Since the increases referred to are in excess of productivity it is possible that (via a rise in real wages) gQ may fall in which case gP will be observed to move to a higher level. The rate of inflation will indeed move up. But unless similar wage increases are granted continuously, causing a progressive decline in gQ , inflation will remain at a permanently higher level. (All this assumes that gk is constant or varies very little. It is difficult to see how wage increases could affect gk greatly. In fact, although this will be discussed further, it is contended that gk is likely to be very close to zero, especially over long periods). As long as there is no increase in the rate of growth of output as a consequence of the wage increase (and we expect the opposite), the wage increase is simply a redistribution of income from employers to workers. If the workers spend more the employers spend less. Further, any reliance on arguments concerning different propensities to consume of these two groups (that of workers being higher) presupposes a continual redistribution to provide an inflationary momentum. Formally it implies a continually falling k .

The argument is sometimes couched in terms of a “wage-price spiral” arguing that employers will recoup their losses from wage increases by “passing on” such increase to consumers. In that case, however, presuming consumers buy the same quantities of the

outputs affected, there has been a redistribution of income away from consumers and other employers to the employers affected. Put more clearly, at the same level (or rate of growth) of real income, if the price of one product rises, and consumers continue to buy comparable quantities of it (an inelastic demand for it exists), they must be spending less on something else. This cannot constitute a situation of general excess demand. If consumers respond to the price increase by buying less of the products affected the same conclusion applies. The weights attributed to high price items will tend to fall in such a way as to maintain the price level (or its growth rate) at its initial level.

A final twist in the argument is to say that the government always expands the money supply (raises gM) to facilitate the wage and price increases without the obvious redistribution effects mentioned above. In this case wage increases though they may precede price increases ultimately do not constitute a real wage increase and gQ should not be directly affected. More important, it is the rise in gM and not the rise in wages that is the immediate cause of the inflation.

“Inflation is a result of a rise in the price of imported goods like oil”

This argument suffers from exactly similar fallacies. A once over rise in the price of imported goods will have only relative and not absolute price effects. As a result of the recent large rise in the price of oil, those consumers and producers who purchase oil-related products are undoubtedly poorer (in a welfare sense). This will be true whenever the relative scarcity of some or other economically useful entity rises. That is the essence of price theory. But to say that it is inflationary is to misunderstand the nature of the inflationary process. All the recent talk about “imported inflation” not only misses the point, but like most similar fallacies diverts attention away from the real issues.

“If people work harder and more efficiently productivity increases will provide a cure for inflation.”

This is potentially one of the most harmful arguments advanced as a cure for inflation. Fortunately, because it is seldom heeded, that potential is seldom realized. Not only is harder work a false cure, and therefore, an attempt at deception, it is also costly in terms of welfare. That it is a false cure should be immediately apparent. Given a rate of inflation gP any attempt to reduce it by raising gQ is unlikely to be effective with the usual magnitudes in question. A rate of inflation around 10% and a rate of growth around 5% implies that the rate of growth must be increased by 200% in order to eliminate inflation or by 100% in order to halve it. Of course the

magnitude of the task is lessened if gk rises with gQ . (This implies a very unrealistically high income elasticity of demand for money if it is to make any difference).

But even if it could be done, solving the inflation problem by harder work is a false solution because the costs of doing so outweigh the benefits. In a market economy individuals have a relatively wide range of choice as to whether they will work or not, where they will work, how many hours they will work and so on. Presumably people value their non-working (leisure) time or else they would work all the time. Indeed, good price theory tells us that the individual will divide his time between work and leisure in such a way that the marginal utility of his hourly wage (including any preference or dislike for the work itself) is equal to the marginal utility of an hour of leisure; or, given indivisibilities, will move as close to this position as he can. To implore an individual to work harder or more is to ask him to substitute increasingly valuable leisure time for increasingly onerous work time. The increase (if any) in final output in the economy is an illusion. It is an increase only in *market output*, but *household output* (leisure), which the individual values more highly, has been lost. The resulting decrease in inflation is by consequence also illusory. The rate of price increase of market output may have fallen, but the price of leisure (which is not registered in any market) has gone up. If we measured the price level of welfare instead of output it would indeed be higher not lower.

Finally, there remains the (subjective) cost in terms of loss of personal freedom implied by any arbitrary interference in a market economy. The appeal to work harder (reminiscent of Orwell's Animal Farm) must be seen by many as an illegitimate intrusion into that part of an individual's affairs he is entitled to consider his own business. It is obviously made worse by our observation that if successful it will harm him and not help the fight against inflation at all.

4. “We need to save more to solve inflation”

Ostensibly, this looks like an appeal to increase k . If so, there is little to be said for it. To solve inflation via this route would require a rise in gk not k , i.e. an increasing rather than a higher demand for money in income units. Most economists would agree that this is an impossible task. But it is important to note that an increase in saving ‘per se’ would, in any case, not do the trick. It would have to be a continuous increase in saving *in the form of money* (what used to be called “hoarding”). But put in this way it is really an indirect appeal for a reduction in the rate of growth of the money supply via the holding of higher reserves. It really has nothing to do with

saving. Saving in any other form is simply a redistribution of income and expenditure from those in credit with financial institutions to those in debit. Once again it is an example of an action with only relative price effects and is also another example of arbitrary interference in private economic decisions that will do no good and may be expected to do some harm if effective.

5. "An incomes policy, if properly implemented, will solve the inflation problem"

This is not so much a fallacy as an exercise in naive wishful thinking. It is clear that a policy designed to curb price and wage increases that would otherwise be made, either by voluntary or legal controls, will not remove inflationary pressures if $gM > (gk + gQ)$. Furthermore, if this situation of excess demand prevails over time the controls will become less and less effective. Black markets will develop and legal methods of achieving price increases will be found. For example, service charges, unit quantity reductions and so on will be used. When the controls break down completely, as they must in a market economy, the resulting price increase will appear even greater than it would have been owing to the artificially low base from which it is observed to increase. The fact that there is not one single acknowledged instance of successful experimentation with price and wage controls (and there are many such experiments scattered throughout history) is reason enough for scepticism.

However, those who favour such policies will argue that they have not been properly implemented, and that governments should combine a policy of financial stringency to remove the excess demand at the same time as controls are applied. It is argued that the controls will act as a cushion in moving from an inflationary to a non-inflationary situation by reducing the costs in terms of unemployment of such a transition.

The germ of truth in this approach should not blind us to the reality of the situation. I will argue below that inflationary expectations indeed do impose a cost on any society attempting an anti-inflationary monetary policy. An incomes policy that can convince the public to revise its expectations of price increases may reduce that cost. The point is that it may be doubted whether any incomes policy has ever done this or ever will. (Formally, inflationary expectations lower k and therefore raise gP for any given gM and gQ . As will be argued below, they may also, for a time, reduce gQ in the face of an anti-inflationary monetary policy).

The hard truth remains that governments have imposed wage and price controls at precisely the same time that they have embarked

on an expansion of government spending through the money supply. The incentive of (artificially) low prices seems to be too much for governments to resist. The result is therefore a doubly onerous inflation tax constituting a transfer from the private to the public sector.

In fact such policies may be legitimately seen as an attempt to shift the responsibility for inflation to private sector individuals who cannot have had anything to do with the causes of inflation, except, perhaps, via the political process. As such they constitute another exercise in deception that will seem to many to be fundamentally incompatible with a free society. The presumption that a government bureaucracy should have not only the ability but also the right to suggest to private individuals how to conduct their business within the framework of the law is repugnant to those schooled in the free enterprise tradition. Not only does such a policy exact a heavy price in efficiency by distorting relative price movements and, therefore, factor movements that have nothing to do with inflation, they also tend to become permanent and immovable fixtures of the economic landscape that encroach step by irreversible step on the dwindling terrain that free enterprise can call its own. In so doing it acts to stifle those forces of inventiveness and ingenuity that have been the key features of the world's all too brief experiment with free markets. In the final analysis it must be said that such policies would be more at home in countries like the Soviet Union or Red China; countries whose example we apparently so determinedly seek to avoid.

5. SOME DEBATABLE ISSUES

The list of fallacies could be extended. Enough has been said, however, to make the point that the causes of inflation are to be found in the relationship between money supply on the one hand and real growth on the other. This being so the area of legitimate disagreement becomes quite clear and a number of debatable issues have emerged.

To recapitulate briefly, it will be remembered that inflation will occur whenever

$$(4) (gM - gQ) > gk$$

Written in this (transparent) way, the condition says that whenever there is an excess growth of money (money growing faster than income), not matched by an increase in the demand for money, inflation will ensue. It thus becomes crucially important to know how gM , gQ , and gk are related. And it is about this that the issues are joined.

- (1) It is sometimes argued that inflation has a momentum of its own in that even if monetary growth is not excessive there may be a continuous decline in k (i.e. gk is negative). In technical language there is a continual and uncontrollable increase in the velocity of circulation of money (equal to $1/k$ in our notation). In times of monetary restriction monetary substitutes tend to proliferate in the face of "autonomous" wage and price increases and thus permit inflation. In the extreme form of this argument, M/k becomes a variable not subject to political control.

Whether or not k (and, therefore, the income sensitivity of demand for money) is a stable variable is really an empirical issue. Much work has been devoted to testing the stability of the demand for money (as a function of money rates of interest and real income) and the predominant conclusion is that such a demand exists and is almost always stable. The one notable exception is the case of hyper-inflation when the demand for money, though a stable function, varies considerably with the rate of inflation. Observation of M/PQ over the broad sweep of history belies any suggestions that it is a wildly fluctuating or unstable variable².

To be sure, k does vary, but the main point is that it does not vary unpredictably and appears to be related in a plausible way to variations in gM , gQ and gP . This will be explored further below.

- (2) Perhaps a more important question is that of the so-called "transmission mechanism". It is clear that any change in gM will produce changes in gk , gQ and gP . It is not clear, however, exactly how these variables will be affected especially with regard to their behaviour over time. This is the important "missing-equation" of modern monetary theory. The issue is both theoretical and empirical. Much empirical work has been done relating the time sequences of the growth rate of the money supply with the other variables. It has been suggested, for example, that an acceleration in monetary growth will be reflected with a sizeable and variable lag in an increase first in the growth rate of output (gQ) and only later in the rate of inflation (gP). Further it seems that while the increase

2. The number of references is too large to reproduce here. Among the seminal works in this field are M. Friedman, "The Demand for Money: Some Theoretical and Empirical Results". *The Journal of Political Economy*, August, 1959; and D. Laidler, *The Demand for Money, Theories and Evidence*, (International) 1969. Mention should be made at this point of the fact that some (a small minority) of economists doubt the validity of using recorded statistics to make inferences about individual economic behaviour. In this particular context they believe that k may indeed be unstable under circumstances not yet observed (or not observed for long enough). Given the wide differences in methodological approach between these economists and those who believe that the only way to make progress in economics is to confront any theory with the "evidence" on an ongoing basis, this issue may never be resolved.

in gP will last, as long as monetary expansion does not reverse itself, the rise in gQ is only temporary. Also, k will be affected at first rising with gQ but later falling with gP ³.

These observations, and the call for a theoretical structure prompted Milton Friedman's work on a theoretical framework to interpret them⁴. This work is associated with a tremendous literature on the nature of the trade-off between inflation, growth and unemployment — the Phillips curve. The earliest statement of the problem in modern terms was by Friedman and Phelps (independently)⁵. Obviously this cannot be discussed here. Suffice it to note that the following propositions have been forcefully advanced.

- (i) There is no long-run trade-off between inflation and unemployment.
- (ii) Employment and output will rise above their trend levels in response to a monetary acceleration only temporarily until inflationary expectations reconcile apparent real wages with actual real wages. That is, expected real wages rise in the process but these expectations are negated in the long-run.
- (iii) The real choice open to society involves a *temporary* decline in unemployment in the present as a result of a *permanently* higher level of inflation in the future.
- (iv) The higher the level of inflation the greater will be the temporary increase in unemployment necessary to reduce it by any given proportion. That is, the higher the level of inflation the more costly it will be to reduce it.
- (v) These costs may be substantially reduced by a policy of widespread price indexation.

The common element in all these propositions is the assumption of the existence of a "natural" rate of unemployment (and growth) in every economy that is independent of monetary and fiscal policy

3. Again the list of possible references is enormous. Important works are M. Friedman and A. Schwartz, *A Monetary History of the United States*, National Bureau for Economic Research, Princeton, 1966; A. Walters, *Money in Boom and Slump*, The Institute of Economic Affairs, 1970.

4. M. Friedman "A theoretical framework for Monetary Analysis," *Journal of Political Economy*, March 1970.

5. M. Friedman, "The Role of Monetary Policy", *American Economic Review*, April 1968; E. Phelps, "Money-Wage Dynamics and Labor Market Equilibrium" *Journal of Political Economy*, July 1968.

except in so far as inflation imposes real costs on the economy by reducing the convenience of money. More specifically, it is a denial of the view that monetary and fiscal policy can increase the rate of growth and employment in the long run and an assertion that it will most likely decrease them if it tries. These are "hot" issues and a consensus has not yet emerged. The most that can be said for the above propositions is that they are consistent with the evidence.

- (3) A special, and important, aspect of the transmission mechanism concerns the supply of money in a small open economy. By a small open economy we mean one whose national income is significantly influenced by international trade, and to whom world prices are given. Much work has recently been done addressing the question as to whether, in such an economy, the money supply can be considered an exogenous variable.

The problem has been stated formally by Harry Johnson as follows⁶. The money supply base (official reserves) of a small country can be assumed to be made up of two sources, domestic reserves and foreign reserves. The country is further assumed to have a fixed exchange rate and a stable demand function for money balances. There is no exchange control.

"The consequences of these assumptions are that domestic monetary policy does not determine money supply but instead determines only the division of the backing of the money supply the public demands, between international reserves and domestic credit and not the money supply; and control over domestic credit controls the balance of payments and thus the behaviour of the country's international reserves".⁷

The crucial question is, how much control does such an economy have over its money supply? If none, it seems bound to accept the rate of inflation imposed on it by its trading partners. In the case of South Africa, domestic inflation appears to be closely related to the balance of payments. Because of her large relative size, America has been seen by some economists as the ultimate source of the current world inflation. An increase in the growth of demand in America has ripple effects all around the world. Some of what would be domestic inflation in America is exported to her trading partners in the form of inflation or exchange rate appreciation, who, in turn, pass on these effects to other nations including South Africa. It is in this indirect way that South Africa's inflation is connected to demand pressures in America. In this context it is significant that the rand-dollar exchange rate is officially pegged. But it is also clear

6. H. Johnson, *Further Essays in Monetary Economics*, Chapter 9, Harvard University Press, 1973.

7. *Ibid.* page 238.

that South Africa's inflation is related to the U.S. with a long lag. The lag in the international inflationary mechanism has not been well worked out and is one of the most pressing issues on the research agenda.

What is clear, however, is that control over the domestic money supply can be maintained if a country is willing to have a freely floating exchange rate. Then it must bear sole responsibility for its inflation. A country that wishes to maintain a truly fixed exchange rate may, on the other hand, have to surrender its monetary independence. In this context it emerges that the real solution to South Africa's balance of payments "problem" is the same as the solution to its inflation problem; that is, monetary restraint and a floating exchange rate. This would have the incidental but considerable advantage of removing the necessity for exchange control and other arbitrary and self defeating interferences in foreign trade.

- (4) The political dimensions of inflation are coming under increasing scrutiny. Given that monetary expansion produces inflation and that inflations are politically unpopular, and given that governments can, in principle, control the money supply, how do inflations occur? The crucial answer to this question comes in two parts. Firstly it appears that inflation is, at least initially, less unpopular than unemployment. But, secondly and more important, inflation is a tax that yields government revenue. It is in a very real sense "taxation without representation" in that no legislative tax increase is required for its implementation. It is a tax in the sense that it taxes the real money balances of the private sector. In the face of rising prices financial assets (including money) become worth less. The government acquires a greater command over resources than it otherwise would have by being able to pay the higher prices it induces. Furthermore, inflation is a tax in the sense that it expands the revenue yielded from a progressive tax structure by placing inflated money incomes in higher tax brackets. It is no accident, therefore, that the highest rates of inflation tend to be found in those economies whose tax base is low relative to its implied government expenditure. *Inflation and the growth of government are inextricably linked.*

How governments are able, over long periods, to get away with this deceit is still not quite clear. Part of the explanation appears to be the fact that the link between government expenditure and government revenue is administratively complex and indirect and thus very difficult for the average citizen to understand. In systems where powerful interest groups are able to lobby for government expenditure on their behalves (presuming that others will bear the cost) in return for political support, governments characteristically

overcommit themselves. Any shortfall of revenue from expenditure usually results in an increase in gM.

F.A. Hayek has recently forcefully advanced the argument that, unless the monopoly to issue and control money is taken away from governments, inflation will not be stopped⁸. If private banks were to compete with each other (and the government) for the revenue associated with the creation of money, no money whose value tended to fall relative to any other's would be held by the public. There would be a strong incentive for any money issuer to maintain the value of its currency, and this includes the government. It is only because we have (erroneously) come to believe that it is the prerogative of governments to issue money that we may find this idea strange. It will appear less so when we think in terms of the international economy where many currencies compete with each other. One peculiar characteristic of domestic transactions in some countries is that they must be made in domestic currency. If transactions could be made in any currency and exchange rates were freely variable, the government incentive to inflate would be drastically undermined. It is certainly worth pondering as a solution to both our inflation and balance of payments problems.

- (5) Finally, of course, there is the issue of fiscal versus monetary policy. The Keynesians apparently still maintain that fiscal policy per se may have inflationary consequences. Insofar as tax, transfer and expenditure changes are really only redistribution policies (assuming no effect on the money supply) it is difficult to see how any inflationary or deflationary momentum can be maintained. For example, for a pure tax increase to be deflationary, if it does not affect gM, must either increase gk or gQ. As a purely logical matter one wonders how this is possible and would indeed expect the opposite because of the dampening effect on private incentives.

6. CONCLUSION

The underlying theme of the above remarks is that of distinguishing between incorrect and empirically debatable statements. I have been very brief in parts owing to the wide ranging scope which I set myself. For example, the treatment of the monetary theory of the balance of payments was intended simply to whet the reader's appetite. It is hoped, however, that the fallacies expounded will indeed be seen to be fallacious and that the real issues will therefore, stand out more clearly.

8. F.A. Hayek *Denationalisation of Money*, The Institute of Economic Affairs, 1976.