

“Inflation”

by Milton Friedman

Paper for Mont Pèlerin Society Meeting, Princeton, New Jersey, September 3-8, 1958

© Mont Pèlerin Society

A third world war is the most obvious threat to the preservation of a free society. If this may be optimistically put to one side, the most serious threat is, I believe, inflation. Inflation is a threat less because of its direct effects than because of the measures that are likely to be taken by government to control the inflation and the effects of inflation on the competitive structure of the economy.

In developing this thesis, I shall consider first, why inflation seems likely to occur in the coming decades; second, why it is likely to undermine a free economy; and third, the policy measures that might be most effective in countering this threat.

**1. *The Prospects for the Coming Decades***

I shall use inflation to mean a substantial, fairly long continued rise in the general level of prices, without any attempt to be precise in specifying what index is to be used to measure the price level or what the magnitude or duration of the price rise must be to qualify.

I take it for granted that a substantial price rise can occur only if there is a substantial rise in the stock of money per unit of output. Though often denied, this proposition is amply demonstrated by a wide range of historical evidence. I know of no historical episode in which there has been a substantial rise in prices without a substantial rise in the stock of money per unit of output or a substantial rise in the stock of money per unit of output without a substantial rise in prices. And instances in which prices and the stock of money have moved together are recorded for many centuries of history, for countries in every part of the globe, and for a wide diversity of monetary arrangements. In this sense, all inflationary episodes are the same.

This proposition is of central importance in any analysis of inflation. However, it is only the beginning, not the end, of a full analysis. What produces the increase in the quantity of money? What are the consequences of the price rise? When measured can be taken to prevent the increase in the quantity of money from accounting? And so on.

In the past, there have been two main sources of an increase in the quantity of money. One source has been physical or technical changes affecting the supply of a monetary medium—e.g. gold discoveries in the 1840's; the development of the cyanide process for extracting gold from ore plus gold discoveries in South Africa in the 1890's. The second main source has been the use of the printing press, in a more or less subtle fashion, to finance governmental expenditures, particularly during or after major wars.

Under present circumstances, the first source is unlikely to be of any great importance since so few countries are on anything like a full commodity standard. To a greater extent probably than in any other period of history, the supply of money is independent of the supply of any physical

commodity and dependent rather on the decisions of politically designated monetary authorities. The second source is obviously of far greater significance. The acquisition of resources by the creation of money is a form of taxation that is subtle and concealed, and that typically requires no legislative action under existing monetary arrangements. With both governmental expenditures and explicit taxes at an unprecedentedly high peacetime level in the United States and other countries, there is inevitably a strong temptation to resort to this indirect form of taxation. However I do not believe that it is likely to prove the most important source of inflationary pressure or even a major source. Recent experience has demonstrated a far more wide-spread recognition of this danger and a far greater capacity of democracies to submit themselves to heavy explicit taxation than many of us would have predicted.

The major present source of inflationary pressure seems to me rather different than those that dominated our past experience, namely, the acceptance by governments of responsibility for full employment which, if not new in kind, is certainly new in degree. Given present attitudes, any decline in employment and income calls forth almost irresistible demands for countervailing government action. Such actions would not necessarily produce an inflationary threat if their effects could be turned on and off instantaneously—if, that is, countercyclical policy were like a water tap. In that case, action designed to offset a decline could be reversed instantaneously when a rise occurred and inflation threatened.

In practice, however, there is a long lag. Action is not taken until sometime after the need occurs and the action taken does not itself produce its full effects for many months after it is taken. Work we have been doing on the relation between changes in the stock of money and in economic activity, for example, indicates that the rate of change in the stock of money has on the average reached its peak nearly sixteen months before the peak in general business and has reached its trough over 12 months before the trough in general business. And what is true of explicitly monetary changes is surely equally true of fiscal and other measures that are one of the sources of these monetary changes. Moreover, the lag in reaction is variable. On some occasions, the effects of a measure may be manifest in 5 to 6 months, on others, not for 20 months or more.

The result of these lags is that each recession tends to leave an inflationary hang over. The resulting price rise will itself not continue indefinitely. The same built-in stabilizers that would bring a recession to an end even without explicit governmental action operate in an expansion as well. Moreover, although the pressure to “do something” to oppose the initial steps of inflation is currently less dramatic and less potent than the corresponding pressures in the early stages of depression, they are certainly present and are likely sooner or later to have an effect. And here, too, measures taken operate with a lag and so are likely to be overdone. In consequence, the inflation is not likely to continue uninterruptedly. The prospect seems to me rather one of a long continued but not continuous inflation produced primarily by the measures taken to counteract the recessions that punctuate it.

Recent experience in the United States is a fairly clear example of the process just outlined. Though reaction to the 1953–54 recession was far less extreme than was urged at the time by many if not most observers, it seems in retrospect to have been overdone, and to have contributed to the inflationary pressures in 1956. These in turn led to a tight money policy in late 1956 and early 1957 which had little effect contemporaneously and hence was continued and

intensified. Its delayed effects in their turn contributed to the recession of 1957–58. The measures taken to counteract this recession have probably had only a minor effect so far; their main effect is likely to be felt only during the coming year or two. It seems highly likely that if there had been less allegedly countercyclical action from 1953 to date, there would have also been less cyclical change to counter.

## ***2. The threat inflation offers to a free society***

A fairly steadily rising level of prices would not, by itself, raise any serious problems for the functioning of a free economy. So long as prices are free to move, the market is sufficiently adaptable to take moderate movements in the general level of prices in stride. This has been true in the past even for fairly large and unexpected price movements. And it certainly would be if the price movements were fairly steady so that they could be anticipated. Escalator clauses would then become widespread and money interest rates would reflect the expected price rise, so that the major effect of the inflation would be the waste of resources involved in keeping money balances at a relatively low level.

I do not mean to argue that such a steady rise in prices is either desirable or possible under present circumstances. I do not myself share the views of those who regard such a price rise as likely to stimulate economic growth. The evidence seems to me to suggest that the mainsprings of economic growth are to be found elsewhere and that rapid growth is entirely consistent with either rising or falling price. As to feasibility, any steady rise in prices under present conditions would be clearly recognized as being produced by explicit action. Initial stimulating effects, if any, would wear off as a further rise in prices was widely anticipated, and there would be steady pressure to increase the rate of rise of prices.

Irregular price movements involving great uncertainty about direction and magnitude and accompanied by or accompanying severe depressions, are a very different matter. They would seriously interfere with the workings of the market and would moreover drastically strain the social fabric. For the United States, the evidence of the 1870's, the 1890's and the 1980's is clear on this point. I regard inflation serious as a more/current threat to our free economy than a severe depression only because I believe it is far more likely to occur, not because the latter would be less serious if it did occur. Severe depressions have occurred in the past only as a consequence of a monetary breakdown involving a sizable decline in the stock of money. Such a breakdown seems highly unlikely with present monetary arrangements and attitudes. Danger to a free economy from the kind of intermittent inflation sketched in the preceding section would arise in the main from two indirect effects.

One, and, in my view, the less important would be its effect on the strength of unions. It is widely believed that strong unions have been an important factor promoting inflation in the past and threatening inflation in the future. In its sophisticated and logically tenable version, this view holds that unions force wage increases that would produce unemployment if monetary expansion were not resorted to, that such unemployment is not politically acceptable, and that hence the monetary authorities under a full employment policy are led to expand the stock of money and permit and promote a price rise. This is perhaps the most widely accepted alternative to the view expressed in the preceding section. I do not myself believe it is valid as a description either of

what has happened in the United States in the past few years or what is likely to happen in the immediate future—wages have to put it crudely, been pulled up rather than pushing up prices. The important relation seems to me the reverse. As I wrote some years back, strong unions may not produce inflation out inflation is almost certain to produce strong unions. The reason is that inflating means a succession of money wage increases. These would have come, union or no union. If a union exists, however, they will come through the union and the union will get the credit for them. The end result might be to make the wage-push argument true. And it will certainly weaken the competitive structure of the economy and render it a far more difficult to stop the inflation without serious transitory disturbances.

The more important indirect effect of inflation is through the measures that are likely to be taken by government to prevent the inflation. The very fact that inflation results from overreactions to the recessions that punctuate it will make it appear that monetary measures are incompetent to prevent it and this will certainly be reinforced by the ubiquitous tendency for the monetary authorities to “pass the buck,” to claim credit for all the desirable outcomes and profess their inability to prevent the undesirable. With existing attitudes, it is almost inevitable that there will be pressure for the government to take direct measures to prevent particular prices and wages from rising—to undertake direct price control and wage control. These measures will in turn lead, in a pattern made familiar by wartime experience, to widespread appearance of shortages and to an almost irresistible pressure for physical allocation and rationing. The market can take open inflation in its stride. It can be destroyed by suppressed inflation, as was demonstrated most dramatically in post-World War II Germany. If indeed we lose our economic freedom in peacetime, this seems to me the most likely route.

Already there are signs that this process is underway. We have seen repeated pleas by the President of the United States in both Democratic and Republican administrations for “voluntary restraint” on the part of business and labor in raising prices and wages. Even such a group of businessmen as the Committee for Economic Development, though in general dedicated to a free economy, has paid at least lip service to the same plea for “social responsibility”. If such “restraint” were in fact to be exercised under conditions of inflationary pressure it would produce the same results as governmental price control. Voluntary restraint is not in fact likely to be exercised. As inflation proceeds, the pleas for voluntary restraint will tend to be replaced by demands for enforced restraint. Already a bill has been introduced into Congress to instruct the Council of Economic Advisers to collect data on price and wage changes and to make recommendations to the group concerned about the “voluntary” restraint that *should* be exercised. There can be little doubt about the direction in which we are moving.

### **3. Appropriate Policy Measures**

The major requisite for preventing these results is indeed “restraint” but not restraint on the part of business or labor with respect to individual price or wage changes. What we need is “restraint” on the part of the public at large in demanding vigorous governmental action at the first sign of a downturn and on the part of governmental authorities in yielding to such demands. The crucial problem is how to get such “restraint.”

I do not myself believe that it can be obtained by the device so much favored by liberals in the Mont Pèlerin, not the American sense of an “independent” central bank. Such independence is contrary to the tenets of our political philosophy and has in practice proved an extremely weak reed indeed. Certainly in the United States, the record of the Federal Reserve System gives little grounds for optimism. Neither do I believe that it can be obtained by the more recently favored device of incorporating price-stability as an objective in the so called full-employment act, coordinate with that of maintaining a high level of employment. The goal is certainly a desirable one. However, it is hard to see how simply legislating the goal will promote its achievement, though I cannot see either that it can do any harm.

The only really effective device, it seems to me, is to persuade the public to renounce the use of discretionary counter-cyclical action and adopt instead a quasi-automatic monetary mechanism. If my analysis is right, our ability to attain a high degree of economic stability is limited. The process of seeking to attain this goal by discretionary action is likely in fact to yield more instability rather than less and in addition to set in strain a sequence of events that will undermine the basis of a free society.

The most widespread quasi-automatic monetary mechanism with which we have had experience in the past is a commodity standard and in particular a gold standard. Such a standard did prevent more than moderate inflation in peace time. But it did not prevent severe monetary breakdowns, it was seldom permitted to operate without interference by discretionary monetary authorities, and it is technically an inefficient standard, involving as it does the curious spectacle of imposing hard labor on some men to dig a metal out of the earth in one part of the world in order to bury it again in another. Moreover, the precondition for such a standard serving as an affective restraint is that it be widely and unthinkingly accepted as “sacred” to the public at large so that “tampering” with it is politically unhealthy. This precondition does not now exist, though perhaps it may after some decades of experience with recurrent inflation. For these reasons, I do not myself regard the adoption of an effective gold standard as either desirable or feasible.

The alternative is the adoption of a set of rules for controlling the actions of the monetary authorities and limiting their discretion. I have elsewhere outlined a set of rules that would serve this function and that would in my view produce a high degree of stability. The extensive empirical work I have done since that proposal was published has given me no reason to doubt that the arrangements there suggested would produce a high degree of stability.<sup>1</sup> It has also, however, led to me to believe that much simpler arrangements would do so; that the major problem is to prevent monetary changes from themselves contributing to instability rather than to use monetary changes to offset other forces. And simpler arrangements have the great virtue of ease of public understanding and of a greater possibility therefore of getting support for them;

For the United States in the present state of our knowledge and with our present institutions, I believe the most desirable simple policy would be to adopt the rule that the money supply should be made to grow at a predesignated rate month in and month out with allowance at most for seasonal influences and with no attempt to adjust the rate of growth to cyclical conditions. The rate of growth that would be consistent with a reasonably stable secular price level is, on the basis of past experience, somewhere in the range of 3 to 5 per cent. It makes less difference

which particular rate, or what specific definition of the money supply, is adopted then that some rate and some definition be accepted and adhered to.

Any full statement of a proposal along these lines would involve presentation of the evidence that underlies it, consideration of administrative and technical arrangements for achieving the desired result, of desirable banking reforms, and of the budget and debt policies implicit in this monetary policy. It would require also consideration of international monetary arrangements since such a policy has as its logical counterpart a system of floating exchange rates among different national currencies. Although it is impossible to consider these matters here, perhaps the skeleton statement of the proposal will suggest lines along which an alternative to either inflation or recurrent instability can be found.

### **Notes**

<sup>1</sup> See my “A Monetary and Fiscal Framework of Economic Stability” reprinted in my *Essays in Positive Economics* ‘University of Chicago Press’ 1958 pp. 133–156.

10/1/12