IESE Business School
University of Navarra
"la Caixa" Chair
of Corporate Social Responsability
and Corporate Governance

Working Paper
WP-1156-E
November, 2016

INFLATION

Antonio Argandoña

IESE Business School – University of Navarra
Av. Pearson, 21 – 08034 Barcelona, Spain. Phone: (+34) 93 253 42 00 Fax: (+34) 93 253 43 43
Camino del Cerro del Águila, 3 (Ctra. de Castilla, km 5,180) – 28023 Madrid, Spain. Phone: (+34) 91 357 08 09 Fax: (+34) 91 357 29 13

Copyright © 2016 IESE Business School.

INFLATION

Antonio Argandoña[1]

Abstract

This is an entry for the second edition of Sage's Encyclopedia of Business Ethics and Society. It is a brief explanation of inflation, its causes and its consequences. Inflation has important economic, political, social and ethical implications for countries, especially because it affects the standard of living and distribution of income among citizens. The entry also discusses how inflation can be reduced and touches upon the issue of deflation.

Keywords: Inflation; Prices; Income distribution; Monetary policy; Ethics

[1] "La Caixa" Chair of Corporate Social Responsibility and Corporate Governance

INFLATION

Introduction

Inflation is a continued and sustained rise in the general price level of a country, or, equivalently, a continuous decrease in the value of money. Specifically, inflation is not an increase in a few prices but in a large number of prices at once; not a one-time increase but an increase that spreads out over time; and not a temporary, reversible phenomenon, such as the seasonal increase in the prices of certain consumer goods, but a sustained increase. Usually, inflation is measured by the change in some price index, based on a basket of goods and services, such as the consumer price index (CPI). Inflation has important economic, political, social and ethical implications for countries, especially because it affects the standard of living and distribution of income among their citizens.

What Causes Inflation?

Many factors may cause the price of a good to increase on a one-time basis. These include an increase in demand for the product, a reduction in supply (a bad harvest, for example), an increase in costs (wages, materials, energy), and a rise in taxes. Nevertheless, these events may explain one-time price increases but not continued and sustained increases in the prices of large numbers of goods over an extended period, which is the definition of inflation.

There is a broad consensus among economists that inflation can be caused only by a high rate of growth of the quantity of money in a country over a long period. That is why inflation is called a monetary phenomenon, expressed as *too much money chasing too few goods*. According to this explanation, if a country's financial system creates more money than the value of the goods available, a bidding war ensues among potential buyers, which leads to price increases. These price increases pass from one market to another and can persist over time if the quantity of money increases. Therefore, in order to explain inflation, we need to understand how money is created and, given that monetary policy is responsible for the control of the quantity of money, we should ask ourselves what role should be attributed to the monetary authorities in the creation of inflation.

However, if it is public knowledge that the excessive growth of the quantity of money leads to inflation, why do governments promote it or allow it to happen? There are many reasons why they might do this. For example, they may be trying to stimulate demand and production, to avoid recession, or to address mistakes or accidents. Historically, the most frequent cause of excessive growth in the money supply has been the financing of the budget deficit. Specifically, when a government spends above its means, it is tempted to ask the central bank for a loan, and that loan gives rise to an increase in the quantity of money in the economy. In many countries, the ultimate cause of chronic high inflation has been the government's inability to finance public spending out of its regular revenues, prompting it to resort to inflationary means of financing. For this reason, many countries have passed statutes that guarantee the independence of the central bank with respect to the government.

Consequently, wherever inflation is high and persistent, it tends not to be an isolated disorder but part of a broader problem in the context of expansionary fiscal policies, populist governments, and central banks held hostage to political pressure or a lack of appropriate monetary policy tools. In the long run, the price increases may become self-perpetuating because, when money is losing value, consumers try to spend it as quickly as possible. Consequently, prices increase to the point where *hyperinflation* may occur, which means that prices could rise at an annual rate of more than 1,000%. Two extreme examples of hyperinflation are Germany after World War I, where the growth rate of prices reached 3.25 million percent in August 1923, and Zimbabwe, where prices grew at an annual rate of 489 billion percent in September 2008.

Although inflation is typically linked to expansionary monetary policy, its deeper causes may be social, political or economical. Often monetary authorities try to accelerate the growth of production and employment in the short term to avoid the recessionary effects of a rise in wages or oil prices or to facilitate a redistribution of income, forgetting that this can lead to higher, more durable inflation in the long term.

Economic and Social Effects of Inflation

Inflation poses economic and social problems, mainly because it has negative consequences for the operation of an economy and the welfare of its citizens. In economic terms, a country with high inflation and a fixed exchange rate will become less competitive, and this may result in low growth and high unemployment. Moreover, the currency of a country experiencing inflation may be subject to speculative attacks that cause sudden devaluations that accelerate inflation and disrupt production. The severe adjustment costs that follow will probably lead to a recession.

An economy with high and variable inflation is likely to be less efficient because the market signals are distorted. For example, companies may find it difficult to determine whether the higher price of a specific good is due to higher demand for this good or to a general rise in many prices, and this confusion may lead to erroneous decisions regarding production and investment. Moreover, price volatility can create uncertainty in the financial markets, and this may shorten the maturity of credit, hindering the financing of long-term investments.

Inflation is also a tax on money, as is evident when considering that the loss in purchasing power of a dollar bill kept for one year with an inflation rate of 10% is equivalent to paying a 10% annual tax on that dollar bill. This result may be considered unfair and undemocratic. Moreover, when inflation is high, the ability to speculate in the financial markets becomes more profitable than work itself.

As the welfare of many citizens is threatened, they may feel wronged. Distributive justice or the fairness of income distribution is at stake. Specifically, high inflation brings about a redistribution of income that particularly harms those on a fixed income, such as public pensions or rents. It also harms those who hold cash or fixed-income securities, as well as creditors, given that the value of payments declines under conditions of inflation. After an episode of high inflation, savers may find that their wealth has evaporated, unless it was invested in securities whose value kept pace with inflation. Additionally, inflation accentuates the income tax progression by pushing the base up into higher tax brackets, without any corresponding increase in real income.

In society at large, high and variable inflation may generate ill-feeling and conflict, because citizens will see how prices increase day by day while their wages increase only once a year. Whenever inflation is high, people tend to pin the blame on minorities, intermediaries or speculators, which can fuel social violence. Moreover, in an environment of high inflation, ethical and social values – such as honesty, industry and saving – may deteriorate. For example, people may believe that it does not pay to be honest because they end up forfeiting their assets while those who resort to financial speculation may make significant gains.

Also, inflation tends to spread. A rise in one price leads to a rise in another and, more generally, prices can push up wages and wages can push up prices in a chain of defensive reactions. The effects of inflation are most severe when its rate is unpredictable and when citizens are unable to protect their wealth from price swings. Inflation harms citizens' trust in the economic system since it affects their purchasing power. On the other hand, low, stable and predictable inflation allows the development of defense mechanisms, such as wage gains obtained through collective bargaining that maintains purchasing power.

How Can Inflation Be Reduced?

If inflation is a monetary phenomenon, reducing a country's inflation rate is the main task of the central bank, which should curb the growth of the money supply and credit by raising interest rates and draining liquidity from the financial system. However, this can be a traumatic process because many households will find themselves in financial difficulties and will curtail their demand. Subsequently, many companies will experience low profits, halt their investments, cut back their spending and lay off workers. Because this is a recipe for recession, many countries that have tried to reduce inflation have found that implementing a restrictive monetary policy is not enough. This policy must also be credible, which is to say that the authorities must have a firm political will to reduce inflation and to bear the economic and social costs of preventing prices from rising.

Furthermore, an anti-inflationary monetary policy will be credible only if it is compatible with other policies, above all exchange rate policy and fiscal policy – that is, the government should control its deficit. Lastly, the battle against inflation will be easier if institutions and policies are in place to facilitate price adjustment (for example, labor market flexibility and open and competitive markets for goods and services) and if they do not resort to so-called incomes policy because, while the freezing of prices and wages may seem to be a useful instrument to avoid the evils of inflation, its consequences are disastrous, especially for low-income citizens, because of the shortages of the goods whose prices were controlled.

Once the inflation rate has been brought down, monetary policy will have to be aimed at keeping it low. This means that the rate of growth of the money supply must be sufficient to finance the growth of the economy in real terms, plus a low inflation rate. Once again, that will require a credible deficit-containing fiscal policy, a sustainable exchange rate and a fair dose of good luck.

All of this brings us back to the attitude that a socially responsible government should take toward inflation. The most important thing is not to allow unduly expansionary policies, which generate inflation. Excessive money supply growth has a stimulating effect on the real economy in the short term, just as alcohol does on a person, but the effect soon wears off, the negative consequences persist and the dose needed to achieve the same effect keeps on increasing.

Inflation is a problem for many countries but has not always been so in the past. During the recent financial crisis it has ceased to be an issue in some countries because what has occurred is negative inflation or *deflation*. This shows the ambiguity of these phenomena: inflation disturbs the efficiency of the economic system but deflation also causes evils. For example, it increases the debt burden of households and companies because debt must be returned in units of a currency whose purchasing power has increased. Real interest rates may be high and there may be barriers to lowering them, while the expectation of falling prices can lead households to delay their consumption decisions to take advantage of lower prices, resulting in reduced demand and an aggravated recession. Prudence calls for moving the economy between the rock of inflation and the hard place of deflation.

– *Antonio Argandoña*

See also Income distribution; Justice, distributive; Monetary policy; Regressive tax; Seigniorage; Wage and price controls.

Further Reading and References

Bagus, P., Howen, D. & Gabriel, A. (2014). "Causes and Consequences of Inflation." *Business and Society Review*, 119(4), 497–517.

Parkin, M. (1987). "Inflation." In J. Eatwell, M. Milgate & P. Newman (eds.). *The New Palgrave: A Dictionary of Economics* (vol. 2). London: Macmillan.

Parkin, M. (ed.) (1994). *The Theory of Inflation.* Cheltenham, UK: Edward Elgar.

Romer, C.D. & Romer, D.H. (eds.) (1997). *Reducing Inflation: Motivation and Strategy.* Chicago: University of Chicago Press.

Siklos, P.L. (ed.) (1995). *Great Inflations of the 20th Century: Theories, Policies and Evidence.* Cheltenham, UK: Edward Elgar.