The inflation debate

Following the success of the first three articles in our series on the topic of money, this time we look at inflation and the arguments surrounding a thorny issue.

In the modern discipline of economics, the concept of inflation has become one of our most polarising issues.

Some argue that a certain degree of inflation is beneficial to the economy, while others say even modest inflation is damaging. While most agree that inflation is high now, some argue it’s far higher than government statistics tell us. And, that there’s been more inflation over the last decade than we’ve been led to believe.

The muddy waters of inflation

To confuse matters further, people can't even agree on the correct definition of inflation. In a monetary context, the term inflation appears to have originated in the mid-nineteenth century. Back then, and into the 20th century, inflation was generally defined as an increase in the quantity of money. This increase in the quantity then naturally led to an increase in price levels of goods and services. Therefore, according to the original definition, inflation causes rising prices.

However in the mid-20th century some economists began to muddy the waters. They referred to rising prices not as an effect of inflation, but as inflation itself. It’s something Ludwig von Mises, berated in his essay ‘Inflation and unworkable fiscal policy’.

“Inflation as this term was always used everywhere, and especially in this country, means increasing the quantity of money and bank notes in circulation and the quantity of bank deposits subject to check. But people today use the term inflation to refer to the phenomenon that is an inevitable consequence of inflation. That is the tendency of all prices and wage rates to rise. The result of this deplorable confusion is that there is no term left to signify the cause of this rise in prices and wages. There is no longer any word available to signify the phenomenon that has been up to now called inflation as you cannot talk about something that has no name, and you cannot fight it.” said the famous economist.

This is why Andrew Bailey’s (Bank of England) recent pleas for businesses not to raise salaries and prices is so absurd. It’s the actions of the BoE, by unleashing government spending and credit creation, which have led to our current quagmire.

To prevent confusion, I’ll use ‘monetary inflation’ when I mean the increase in the supply of money and ‘price inflation’ when I mean an increase in price levels.

CPI as an objective metric?

When the BoE or government officials refer to inflation, they almost always mean price inflation, and more specifically the consumer price index (CPI). In theory, CPI records changes in the price of 'shopping baskets' so the public can track their purchasing power over time. In practice, however, CPI just allows the government to push a specific narrative, usually that price inflation is modest and that their large spending sprees have no implications.

The CPI has two major flaws. The first is it's not an objective measure. The CPI basket of goods is updated at whim by the Office for National Statistics. Updates, like the substitution process, assumes that, if for example the price of beef rises, people will simply switch to chicken, resulting in lower CPI growth.

"Show me the incentives, and I'll show you the outcome," legendary investor Charlie Munger once stated. Lower inflation justifies higher government spending programmes while also lowering government liabilities on CPI-adjusted obligations like state pension payments and inflation-linked gilts. How can we trust CPI to be an objective metric when the government has such strong incentives to make it appear low and complete control over its inputs?

The second CPI flaw is the idea that a single static metric can convey the level of price inflation throughout the entire economy. Simply absurd. A person's level of price inflation is entirely subjective. It's been extremely low over the last decade for teenagers who live with parents, eat fast food, and play video games all day. Yet, extraordinarily high for those hoping to buy a home, send children to university, and retire soon.

Creating the illusion of low price inflation

Over the past decade there's been two factors that combined to cause this dichotomy; central bank monetary inflation and technological price deflation.

Central bank monetary inflation is the process which increases the money supply. In reality, the UK's money supply is not increased by printing presses but by adding a few digits on computer screens. In an interview in 2020, Jerome Powell, Chairman of the Federal Reserve agreed that they had flooded the system with money. When asked how, he answered "We print it digitally. So as a central bank, we have the ability to create money digitally."

So central banks have the ability to inject trillions into the economy with the click of a button. And as it has worked since the beginning of civilisation, when more money circulates prices move higher.

On the other hand, technological price deflation is the idea that technology naturally improves productivity and lowers costs. This is the reason why TV's, smartphones and video games have seemingly been immune to the price inflation. This massive price decrease is a natural consequence of the exponential growth at the heart of our current digital age.

These two forces act against each other creating the illusion of low price inflation. In reality prices would be far higher if it wasn't for rapidly improving technology, and far lower if it wasn't for a rapidly increasing money supply. (Refer to the illustration of this concept at the end of the article.)

Working harder but going nowhere

Most people have it ingrained in their minds that prices just naturally rise, as if ordained by God. This is completely false. As each year our knowledge grows and we build more efficient systems, prices have a natural tendency to go down.

Central Bank monetary inflation means we have to work harder and harder just to stay in the same place. Meanwhile, human ingenuity and technological innovation work to lower the cost of abundance and prosperity. In order to fully enjoy the benefits offered to us by technology we must embrace falling prices, rather than demonising them.

The gift of price deflation

Modern British universities teach price deflation as a dangerous phenomenon, to be avoided at all costs. The reasons for this are less important than the consequences.

Yet price deflation has gifted nearly every British household the opportunity to own a smartphone and flat screen TV. Just 20 years ago this level of widespread abundance would have been unthinkable.

Now imagine if this abundance could be spread to other areas of the marketplace.

There are solutions to these problems, we only need to embrace them.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

250 Fowler Avenue
Farnborough Business Park
Farnborough GU14 7JP

Marlborough House
Victoria Road South
Chelmsford CM1 1LN

T: 01252 894883
E: enquiries@cartwright.co.uk
W: pensiontrusts.cartwright.co.uk