

TRANSCRIPT

ARC-TV June 24, 2022

Working Title: Stagflation: A feature, not a bug

Subject: Stagnant economic growth

Theme: Stagnant economic growth is a feature, not a bug, of inflation

Contrast: Most economists think inflating prices and economic growth go together

Hello everyone, welcome to Finance Friday at the Ayn Rand Centre – UK. I'm speaking today from Jackson Hole where summer has finally arrived, and the magic weather of this beautiful place is finally upon us. On this day June 24, 1509, Henry VIII was crowned King of England in Westminster Abbey. Henry presided over a period of major price inflation that lasted most of his reign. Was it his fault? I have no idea, that's a story for another day.

I want to mention upfront, so I don't forget, that I will not be presenting next Friday due to a board meeting I have to attend. But I will be back on July 8 with an interview with economist Brian Simpson talking about his new book *Declaration and Constitution*, in which he critiques and re-writes important elements of our founding documents from a rational, free-market perspective. That will be a slight diversion from my normal subject of modern money creation and its consequences, but we will try to address the founders' intent regarding money creation during that discussion, so I hope you will join the show then.

Today I have a somewhat eclectic set of topics.

So the order of the day will be, first, a few little-known but interesting contemporary economic facts that I ran across in my weekly reading, things I think are worth sharing. And in that department of interesting financial facts I will mention first the Fed's unusual method of communication, and then a couple of interesting articles from the *Wall Street Journal* on the recent failures of expert economists.

Then, next, I want to address some very good questions I got from readers after last week's discussion on why price increases showed up in assets long before they showed up in consumer prices. These questions were so good I thought it was important to share them with you all.

Then these questions will lead us right into the main "thought question" of the day which is: what is "stagflation" and what does it mean if it means anything at all?

OK so let's warm up with some interesting things I read this week. One of the great things about studying money creation and its consequences is that the consequences of money creation are everywhere we look. Reminds me a little of energy production and energy policy. Because, like energy policy, monetary policy affects every economic decision we make, every day, although monetary policy's effects are not quite as obvious as the energy policy's effects.

So first, let's talk about the US Federal Reserve, the Fed, the greatest money creator in history. Fed Chair Powell has said he has three methods to implement monetary policy. You already know about two of them – the regulation of interest rates by setting short term interest rates directly and by open market operations to influence the money supply. But maybe you did not know about the third method of implementing monetary policy called "forward guidance," in which the Fed communicates

its intentions to the world through the media. In this forum, we talk a lot about the first two, but today let's take a look at the third so-called "tool" of monetary policy, forward guidance.



Nick Timiraos [Follow](#)

Reporter, The Wall Street Journal

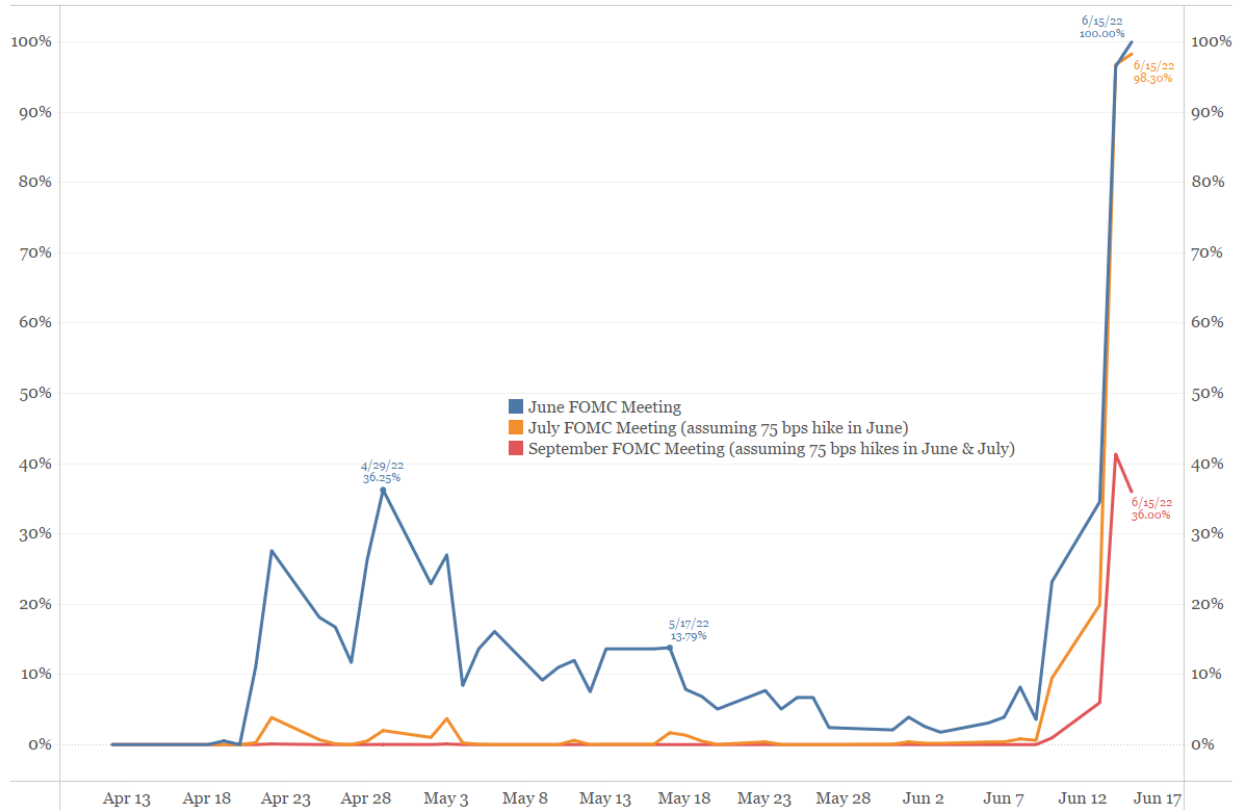


Nick Timiraos is chief economics correspondent for The Wall Street Journal and is based in Washington. He is responsible for covering the Federal Reserve and other major developments in U.S. economic policy.

Have you ever heard the name "Nick Timiraos"? Most of you, probably not. Nick is a veteran economics writer for the *Wall Street Journal*.

It turns out Nick is the primary conduit for Fed "leaks" about their policies and policy changes. When the Fed wants to communicate a change in policy, someone at the Fed literally calls up Nick, and apparently only Nick, to communicate its latest changes. Do they speak to him in code or under conditions of confidentiality? I am not sure, but Nick is so well known for his tight connection to the Fed that he is sometimes called "Chairman Nick."

Probability of Consecutive 75 Basis Point Hikes at the Next Three FOMC Meetings
As Calculated by the Chicago Mercantile Exchange's Fed Watch Tool



Source: Chicago Mercantile Exchange
<https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html>

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To see how this communication method can affect markets, take a look at this chart from Bianco Research. Let me explain this chart. Commodities brokers trade a futures contract to guess what the fed funds rate will be on a certain date. Based on the aggregation of all these contracts, the Chicago Mercantile Exchange calculates the estimated probability that the Fed will make an interest rate decision by a specific date. As more traders' concentrate their bets around a certain outcome, the probability of that outcome rises. What we have in this chart is the probability of Fed rate hikes of 75 basis points (3/4 of a percent) at the next three Open Market Committee meetings. So you can see for example the blue line says that up until about June 12 the probability that the Fed would raise short-term rates by 75 basis points was under 10%. (everyone thought it would be 50 basis points)

So with that in mind, just for fun, see if you can spot the day on the graph when Nick Timiraos tweeted that the Fed would likely raise rates by 75 basis points. Prior to that day, the fed funds market was pricing in less than a 10% chance. But as soon as the Fed leaked to Nick that they were considering a 75 basis point hike, he tweeted his new "opinion," and the probability in the fed funds market went to 100%. That happened within a day.

So leaking information to Nick is one major way the Fed communicates with the public, and I find it fascinating that they do it through a designated unofficial mouthpiece.

OK that's a little inside baseball on how the Fed communicates its policies, and I think their use of the media there is interesting.

Next, here's something else interesting I came across this week. It was in the Wall Street Journal, and it is in the category of "Expert Opinion." In general, I have respect for many recognized experts, but I also know that designated experts can be very, very wrong, especially in the field of economics. I also know they can be highly partisan, politically, and if you don't understand that when you read them, you risk absorbing lots of bogus information and just plain noise.

Case in point was a pair of recent articles in the Wall Street Journal. The first was on the editorial page, June 1.

When Progressives Fail, Inflation Edition

Why the public has lost confidence in claims to authority.

By [The Editorial Board](#) [Follow](#)

June 1, 2022 7:03 pm ET

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This article names 17 winners of the Nobel prize in economics who endorsed President Bidens economic plan called "Build Back Better." Here they are:

Nobel Prize Winners Who Endorsed the Biden Agenda in an Open Letter in September 2021

George A. Akerlof	Georgetown
Sir Angus Deaton	Princeton
Peter Diamond	MIT
Robert Engle	NYU
Oliver Hart	Harvard
Daniel Kahneman	Princeton
Eric S. Maskin	Harvard
Daniel McFadden	Cal Berkley
Paul Milgrom	Stanford
Roger Myerson	University of Chicago
Edmund S. Phelps	Columbia
Paul Romer	NYU
William Sharpe	Stanford
Robert Shiller	Yale
Christopher Sims	Princeton
Robert Solow	MIT
Joseph Stiglitz	Columbia

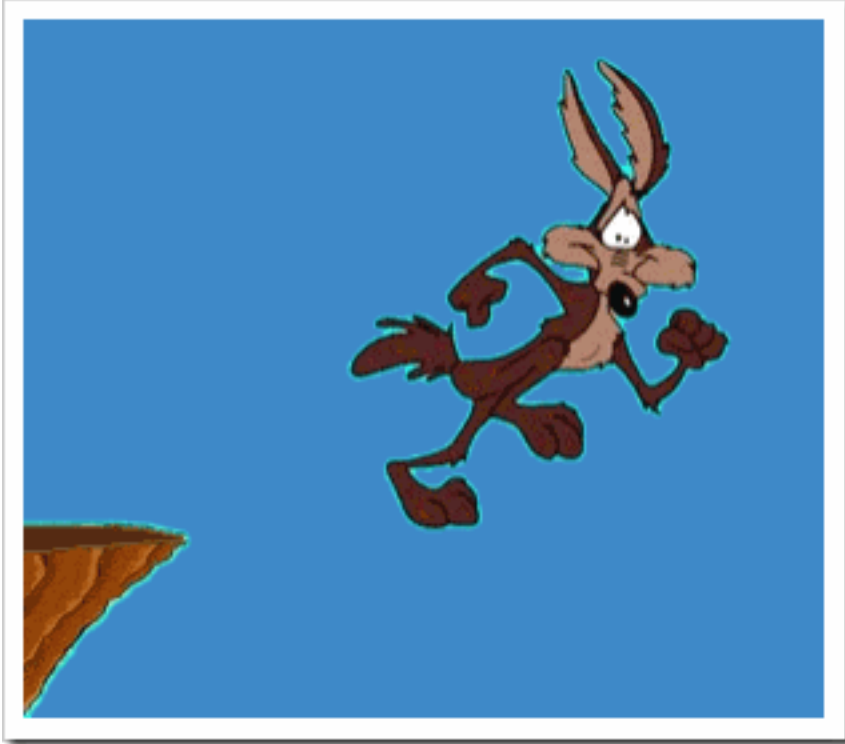
Source: Economic Policy Institute

These folks are criticized here for signing a letter claiming Biden’s BBB plan would actually be good for inflation. They pushed this agenda for months even as evidence of inflation became too obvious to ignore. Inflation was supposedly “transitory.” The White House kept pressing its Build Back Better (BBB) plan for nearly \$5 trillion in new spending—and even claimed it would be a cure for inflation.

No these 17 Nobel prize winners in economics endorsed all this in a remarkable “open letter” last September. The White House broadcast the letter far and wide, and Mr. Biden referred to it often as an appeal to authority. A quote from the letter: “Because this agenda invests in long-term economic capacity and will enhance the ability of more Americans to participate productively in the economy, it will ease longer-term inflationary pressures,” said the letter.

As this editorial pointed out, these economists “ignored the role of excess money, forgetting economist Milton Friedman’s famous lesson” that inflation is always a monetary phenomenon. As President Biden declared in an April 2020 interview, “Milton Friedman isn’t running the show anymore.” That is one campaign promise he has kept.

Since BBB didn’t pass, they can say the inflation prediction in their letter was never tested. But I think their inability to see in September of 2021 that consumer prices were already rising fast makes their letter a failure of expertise.



The failure of the experts (including the economists at the Fed) to see the risk of rising consumer prices reminds me of my favorite cartoon character, Wile E Coyote, who runs headlong over the cliff before realizing the consequences of not paying attention to where he's going or how fast he's going there.

What were these smart people thinking? Why would they claim \$5 trillion in spending would *ease* inflationary pressure – especially when most of this gigantic sum had to be paid for with newly printed money, and they had to know that? You would think an honest or competent assessment from a career professional would at least acknowledge the risk of price increases in the face of all that money creation. Maybe these economists were misinformed, but more likely they are just partisan supporters of a government spending agenda but not admitting it.

The second article in the Expert Opinion Department is this one from the Wall Street Journal.

On Inflation, Economics Has Some Explaining to Do

Models that worked for decades broke down during the pandemic, and alternatives have yet to emerge



Economists have struggled to explain how inflation suddenly shot from around 2% before the pandemic to 8.6% in May.

This [article by Greg Ip](#), a good journalist, criticizes the “output gap analysis” that most economists employ to explain production and inflation. The output gap method basically says there is a potential production rate at which the economy can run, and as long as the economy is operating below its potential output, you can stimulate it (i.e., keep injecting new money) without causing price inflation. Using this framework, the economics profession failed, almost uniformly, to anticipate the recent surge in consumer price inflation.

Ironically it was a left-leaning economist, Larry Summers, who was a notable exception to the opinion of the economics crowd. Summers warned that the huge monetary stimulus during the Pandemic was likely to cause a rapid CPI rise, and he was correct. You may recall from last week that Summers is behind a project to calculate consumer price increases on the same basis as it was done in the 1980s, so we can get a more consistent comparison between then and now. And using that consistent method puts today’s consumer price increase in the double digits, an all-time high.

So, there are two examples of how the designated experts, including mainstream economists, including the Fed, and many Nobel laureates, can get it wrong. In my many years as an investor, I have

learned time and again to listen to the experts but not to trust them. Call me a skeptic if you want to, but I would advise everyone do the same. "Trust but verify" does not work. Better to "verify" and then trust your own conclusions.

Ok, now let's pause for a moment for any questions or comments before I delve into questions from last week.

OK, now for readers' questions. To set the context for these questions, this is what we covered last week:

When a commercial bank buys a bond, the bank creates new credit money to pay for it.

When the Fed buys a bond from a commercial bank, the Fed creates new bank reserve money to pay for it.

When the commercial bank and the Fed do these transactions simultaneously, the operation is called Quantitative Easing, and both new credit money and new bank reserves.

An important point is: Only the bank's "credit money" (a bank deposit, M2) can be spent in the economy, so the Fed's action itself does not create new money, but it does enable the banks to continually create money by creating demand for assets like bonds.

Reader Duncan wrote:

"Thanks Jim, very informative.

Question 1: "After asset purchase [by the Fed], the commercial bank sees a 1:1 increase in reserves and deposits. Can the commercial bank then use those new reserves to potentially create 10x of new loans and new money (i.e., is there a multiplier effect due to min reserve requirements, and did commercial banks do this)?"

The short answer is yes, sort of, but there is some nuance here. The Fed used to require that every US bank had to carry a minimum amount of bank reserves as a fraction of its loans - a "reserve requirement ratio." The typical textbook ratio is 10%, but in fact, the RRR was almost always much less than that. If the bank's reserves fell below the RRR the bank would have to go to another bank and borrow enough reserves to maintain its regulatory minimum. However, in March 2020 the Fed reduced its RRR to zero. This new policy matched the zero RRR in some other countries, such as the UK and Canada, which have not required reserve minimums for many years.

The important point here is, bank regulators (in our case the Fed) *could* specify a minimum level of reserves to constrain loan formation, but, in fact, this has not been done for many years. Instead, central banks, including the Fed, have always supplied the banks with sufficient reserves to meet cash withdrawals as the commercial banks expand their loans and deposits. So, loan growth has determined reserves, not the other way round.

So, the loss of commercial bank reserves does not affect the bank's ability to create new money (lend) because reserves are not a constraint on money creation. But reserve levels theoretically could be a constraint if the Fed were to reinstate its reserve requirements. Also, remember the main reason for

the bank holding reserves: These reserves can be converted to currency on demand to meet withdrawals. Banks like to keep enough reserves on hand to avoid a run on the bank.

For reference, the [Bank of England article](#) I cited explains that reserves are not a constraint on loan formation. (“Money Creation in the Modern Economy”). The major constraints on loan formation are market factors (mostly profit and loss) and regulatory factors, such as risk assessments.

“Question 2: What happens when the government debt held by the Fed matures and rolls off? Does the process work in reverse: the commercial bank sees a 1:1 decrease in reserves and assets?”

No, after the Fed buys the government bond, the Treasury owes interest and principal to the Fed. At that point, the commercial bank is no longer involved.

The US Treasury has its own account with the Fed and holds its deposits in the form of reserves (not called “bank reserves,” because the Treasury is not a bank. Remember reserves are special money for interbank usage). When we pay taxes to the Treasury, commercial bank deposits decline (money as defined by the Fed, M2, goes out of existence temporarily), commercial bank reserves decline, and reserves held by the Treasury increase. The bank is paying the Treasury by transferring its deposit at the Fed to the Treasury. The Fed’s reserves (liabilities) stay the same, they just shift from being owed to the commercial bank to being owed to the Treasury. Then when the Treasury spends money in the economy, the Treasury sends checks to its recipients (like a social security check) which is deposited in a bank, and the reserve asset goes from the Treasury back to the commercial bank. Money then comes back into existence when the Treasury spends money.

So, the act of the Treasury spending its money increases commercial bank assets (bank reserves) and liabilities (bank deposits - money) but does not change the Fed’s liabilities, which simply shift from the Treasury to the commercial bank.

Now to answer Duncan, what happens when Treasury debt matures and is paid off: When the Treasury pays off a bond owned by the Fed, the Treasury, which holds its money at the Fed) reduces its deposits to extinguish its debt to the Fed, and the Fed asset disappears. The asset (bond) disappears, and the Treasury’s deposit (Fed liability) disappears

Similarly, when a bank loan or a bond held by a commercial bank is repaid, money, in the form of a bank deposit, goes out of existence. The process works in reverse of the process of money creation – the bank asset (loan or bond) disappears, and the liability (bank deposit) also disappears.

BTW, Duncan’s question raises an interesting point about the definition of the money supply. M2, or spendable money, does not include the Treasury’s deposits at the Fed (called reserves) even though the Treasury can and does spend that money in the economy. This is why some measures of money supply, like the “Austrian Money Supply,” include these Treasury balances when calculating the money stock. I agree with the AMS definition on this point.

Finally, Duncan corrected me regarding my claim that commercial banks were responsible for student loans. He pointed out that this is no longer true. 92% of US student loans are now direct federal loans. Duncan says: “Private banks were crowded out of the student loans market 12 years ago, and clearly the blame for the explosion in education costs and student debt rests solely on the federal government.”

Duncan

Thank you for setting me straight on the guaranteed student loans - my information was clearly out of date! But, as Duncan points out, student loans funded by taxpayers are still the cause of higher tuition costs, it's just that they are not funded with newly created money from the banks. Still, the lending program does illustrate the principle that directing additional money to purchase any commodity drives the price of that purchase up.

So, thanks for those questions and the correction, Duncan.

Next, Anders wrote the following:

Question: I've always thought that in a capitalist economy without government involvement in money creation and hence no inflation, aggregate prices on goods and services would always trend down due to productivity increases, new inventions, etc. All else equal, this would mean that our money would go further year by year. We've seen some of this in the freest sector of the economy, information technology, where value creation has been immense over the past 40 years. Hypothetically, if this downward trend in aggregate prices would be -5% per year across all sectors, couldn't one argue that the Fed's arbitrary 2% inflation goal means that goods and services have seen a 7% annual inflation rate the past couple of decades (2- (-5))?

So, to Anders I would say, yes, I believe you have approached this question correctly. As you say, the normal course of economic progress under capitalism is to increase production through technological progress, which drives down nominal prices because the supply of goods and services is increasing in proportion to the demand. You're probably aware that at another time of great productivity increase - the late 19th century - prices in the USA trended downward for several decades. This was a time of progress, prosperity, and declining prices under a gold standard. But at any rate, Anders is right, the alleged trade-off between growth and prices, the notion that economic growth must entail higher prices, is not correct. So, I agree with Anders that the normal course of capitalism is rising real production and falling prices.

But I would also say always be careful calling price increases "inflation." This is hard to avoid in common usage and daily conversation, and sometimes you just cannot avoid it because practically everyone equates inflation with price increases. But I think every time you do this you risk creating confusion in your own mind. So, in Anders's example, he says: "Hypothetically, if this downward trend in aggregate *prices* would be -5% per year across all sectors, couldn't one argue that the Fed's arbitrary 2% *inflation* goal means that goods and services have seen a 7% annual inflation rate the past couple of decades (2- (-5))?"

My quibble is it's better to say you have seen "7% real price increases" over the time period. Meaning prices were 7% higher than they might have been with no monetary expansion. And it is inflation that caused those price increases. The rising prices are just the most obvious result of inflation, which is best defined as an undue increase in the money stock caused by the government.

Ok, now finally, here is a two-part question from Andrew:

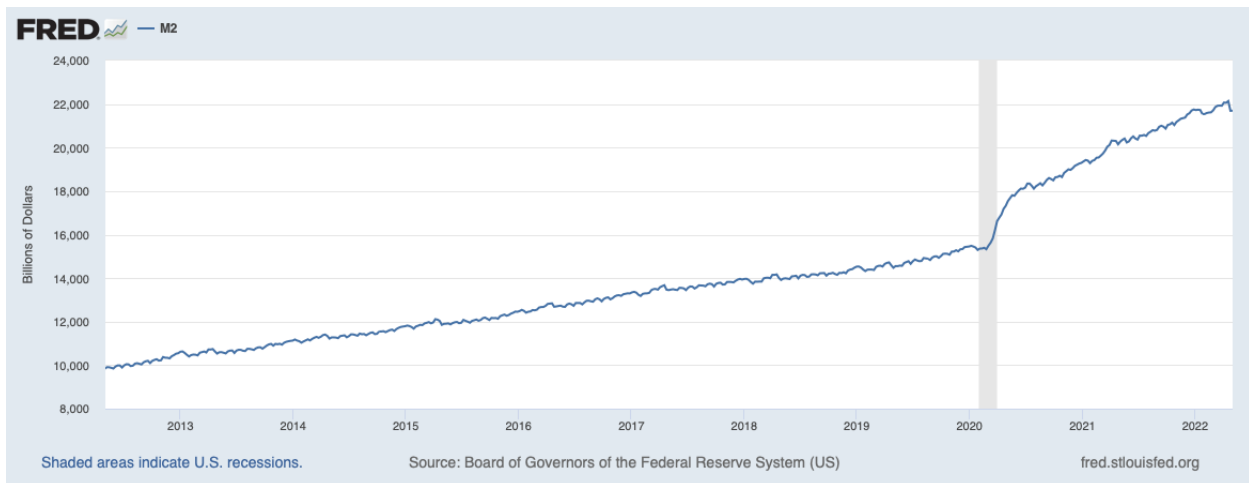
Here is Andrew's first question. "I just listened to your YouTube video of the explanation for where the inflation was during all those years of quantitative easing. It makes a lot of sense, including your

explanation of the beneficial effects on consumer prices of the increase in productivity due to improved technology, improved business methods, and globalization.

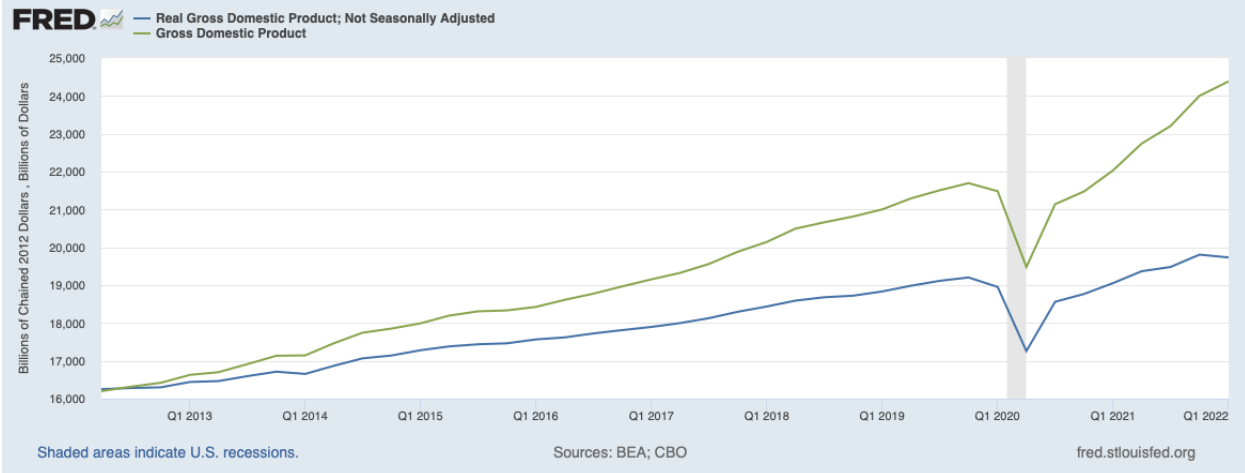
I look forward to hearing your explanation of why we are now seeing consumer price increases when we had not seen them earlier.”

Well, I am not going to try to fully answer why we are just now seeing big consumer price increases, except to make some general comments. Remember the cigar store analogy. If the cigar store sells the same number of cigars each week, but the amount of money spent on those cigars increases, then the average price of cigars must go up. Not only must their average price go up, that is the only reason the price can go up - as long as the quantity of cigars sold does not decrease, the price can go up only if more money is spent on cigars.

So, regarding the US economy, we know that after the initial reaction to the lockdowns, the quantity of consumer goods sold did not decline, but continued to rise. Therefore, the CPI price increases we have seen must be caused by more money being spent on the goods included in the CPI.



So first, here is the mountain of money injected into the economy during the pandemic.



Here is a picture of GDP from the last ten years. The top green line is nominal GDP, the bottom blue line is “real” GDP, or gross domestic product corrected for consumer price increases. Real GDP is an indirect measure of the quantity of goods (it is mostly consumer goods) sold during the previous year.

It is clear from the real GDP (lower) line that the real quantity of goods and services sold *increased* during the period, so we know the quantity of goods sold, the supply of goods, didn’t go down. We can also see there was an increase in the dollars spent in the top line, the nominal GDP line. The dollars spent went way up. So, we know from this data (assuming it is at all accurate) that consumers spent more money during this period when prices were rising fast, and that the supply of goods didn’t decline. So, to me, it’s clear it was more money, not less goods, that caused consumer prices to rise.

Now the question is, where did that additional demand, that additional spending, that additional money, come from? Could it have been from unused cash balances? No, consumers don’t have that much money in their bank accounts or under their mattresses. So, this is the question we must answer, where did the additional money come from?

The short answer is that it came from a combination of government policies and programs funded mostly by the Fed, and partly by the commercial banks. It was a combination of direct Fed lending (something the Fed does that we have not talked about before), commercial bank lending guaranteed by the government, and direct transfer payments from the government that were ultimately funded by the banks and the Fed through QE. Beyond that, I am going to defer the detailed answer, as it will take a good bit of research to document it all if I can do it.

Andrew also goes on:

“I wonder if we are also now seeing a falloff in productivity as the benefits of the deregulations that happened in the 80s have been replaced by increased regulations and as globalization is turning back into nationalism. What do you think?”

I wrote about this in March (“[Monetary Cancel Culture](#)”). I do think the trend will be to “re-shore” some industries to the USA that were being done more cheaply in other countries. But it would be easy to over-predict on this. Globalization is not dying, but I suspect it is a little bit sick, and that may be in part due to an impulse of nationalism, but it may also be in part due to a reasonable re-shoring

of defense industries because China's production of key defense components, like some key semiconductors, is a security risk. As to the regulatory state, I am no expert on regulation, but regulation definitely hinders production, and we have the arch example in the fossil fuel industry, perhaps the most basic industry of all, and regulatory restrictions there have knock-on effects to nearly every other industry.

Andrew's question provides a good segue to the last topic for today, the issue of "Stagflation."



Stagflation:

A "portmanteau" that combines the meanings of two other words into a single word. In 1965, attacking the government's economic policy in the House of Commons, Mr. MacLeod described the present situation in Britain as "Stagflation" – stagnation and inflation together.

(Glasgow Herald, Nov 18, 1965)

The term "stagflation" is one of those words known as a "[portmanteau](#)," or a word that combines the meanings of two other words into a single word. stagflation (n.) Was first coined in 1965, apparently coined by U.K. politician Iain Macleod (1913-1970), from *stag(nation)* + *(in)flation*.

(Note the Brits also gave us other famous portmanteaus like "smog" (for smoke plus fog) and "Brexit" for the proposition that "Britain" should "exit" the European Union.)

"Attacking the Government's economic policy last night in the House of Commons, Mr. Iain Macleod (West Enfield - Con.) the Opposition spokesman on Treasury and economic affairs, described the present situation in Britain as "stagflation" — stagnation and inflation together. [Glasgow Herald, Nov. 18, 1965]"

Now notice that "stagflation" is stated as if it's a weird situation, a combination of two phenomena that are not supposed to happen at the same time. Basic Keynesian economics says that stimulating consumers to spend will spur production, so you should get economic growth right along with consumer price increases. But when you get both rising prices and declining, or slow real economic growth, this is allegedly a freak occurrence, an exception called "stagflation."



If you look carefully at the GDP chart again, at the blue line on the far right, you see that real GDP actually declined slightly in the latest reported month. And you probably also know that most investors and economists believe that if you get two quarters in a row of declining real GDP, then that is called a ‘recession,’ an economic contraction, or a reduction in economic growth.

Based on the chart, and on other evidence in the economy, we might even have already entered a recession. I suspect we are in recession, but we will not know for sure till several more months of data are reported. Today we even have “full employment” with an unemployment rate of 3.6% and yet real production is just crawling along, not soaring. It’s not supposed to be that way according to the output gap model, according to the Keynesian model. When unemployment is that low, we should be growing fast, yet we are not growing fast, and we are even possibly declining.

So, this situation already looks very much like “stagflation” to me, and it will probably get worse.

So, the question I want to address is this: Is stagflation, a decline in real growth combined with widespread price increases, not supposed to happen, as most economists contend? Or can we readily explain how and why these two phenomena can occur together?



In short, is “stagflation” a feature or a bug in the government’s program of monetary expansion? I say it is a feature, not a bug. This means it is normal, and expected, that it is normal to get economic stagnation right along with inflation.

First, remember that inflation is an undue increase in the money stock caused by government. Inflation is not rising prices. Rising prices are merely one result of inflation.

Another less appreciated result (less appreciated because it is hard to see, whereas prices are very visible) – another result of inflation is distorted price signals and the resulting misallocation of capital that causes a slowdown in real production.

Government money creation always involves giving the new money to someone the government wants to give the money to. And these recipients of inflation money are people or groups that could not attract private investment of earned capital in a competitive market. That’s why government inflates: to give money to preferred recipients, to give them economic power they have not earned.

So right there it is easy to see that the free market regards these inflation recipients as non-productive. If they were productive, they would have received investment money. The Pandemic stimulus was a perfect example. New money was just handed out to citizens and businesses. Some of these recipients had already been prevented from working due to government lockdowns, which of course was a travesty. But the fact is, the recipients of the new money did nothing to earn it, that is, they produced nothing in exchange for the new money they received.

All money, all dollars, are a claim on real wealth. Granting new claims on wealth in exchange for nothing (inflation) always causes a transfer of wealth from wealth-generators to non-wealth generators. The wealth generators then lose some of their ability to create more wealth. In this way, inflation weakens both the wealth generation process and slows down the pace of economic activity.

HERE IS THE KEY POINT: money printing gives claims on wealth (new dollars) to those who have not earned those claims. Thus, inflation diverts wealth – that is, real savings – out of the hands of the legitimate wealth producers, and into the hands of those who do not produce. When wealth generators have less real savings to work with, they cannot generate wealth as fast as they previously could.

So, inflation, which diverts wealth out of the hands of the productive elements of the economy, must cause real growth to slow down. If enough wealth is diverted away from the wealth creators, economic activity and real growth will contract, which seems to be happening now.

Note that this reduction in economic output, caused by inflation, is something quite different and in addition to, any slowdown in production caused by government regulation and intervention. For example, government regulation restricts fossil fuel production. Less fossil fuel production means slower economic growth. In a similar way, heavy taxation slows economic growth. But regulation and taxes are different from inflation in that their effect on production is more obvious, whereas the effects of inflation are harder to observe directly.

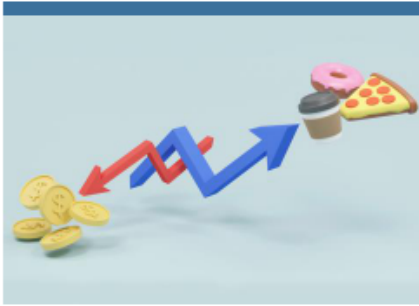
I think the reason for this is that the diversion of wealth from producers to non-producers happens through the market pricing structure which *seems* to be intact, but which is sending false signals to market participants, unbeknownst to them. For example, **inflation distorts market prices, making some ordinary people think they are rich, encouraging them to purchase luxury travel or buy an extra house when they really cannot afford it. They should be taking stay-cations and saving their money for the rainy day, which is coming. But they don't know this because they believe the prevailing prices they see. Inflation, via this money illusion, disguises their impending poverty.**

To illustrate the difference between value destruction caused by taxes or regulation, versus the value destruction caused by inflation, here is an analogy. Suppose I have dairy farm, some cows, and a tank where I store the milk. If the government through regulation does not permit me to milk my cows, I will readily see the loss of production. Or, if the government seizes some of my milk as a tax, that loss is also obvious.

But if the government comes along in the middle of the night, siphons off some of my milk, and then tops off the tank with water, so it looks the same as before the theft, it might take me a lot longer to realize that while the milk tank is still full, the quality of my milk – its life-sustaining value – has been severely diluted.

This is what “stagflation” is about. Government monetary expansion, over time, always results in higher prices and stagnation – or “stagflation” – although often this is not immediately visible. As the pool of real wealth gets drained under a policy of inflation, the phenomenon of “stagflation” becomes all too real. The eventual slowdown in production, or slower economic growth, is caused by the inflation itself.

What Is Stagflation and What Causes It?



37 COMMENTS

[LEE ESTO EN ESPAÑOL](#)

TAGS Central Banks, Inflation, Unemployment

06/09/2022 • Frank Shostak

The occurrence of stagflation is associated with a situation of general strengthening in the momentum of prices while at the same time the pace of economic activity is declining. A famous stagflation episode occurred during the 1974-75 period, as year-on-year industrial production fell by nearly 13 percent in March 1975 while the yearly

growth rate of the Consumer Price Index (CPI) jumped to around 12 percent. Likewise, a large fall in economic activity and galloping price inflation was observed during 1979. By December of that year, the yearly growth rate of industrial production stood close to nil while the yearly growth rate of the CPI closed at over 13 percent.

Let's close with a few choice excerpts from a [good article on stagflation from Frank Shostak](#), which I recommend for its clarity. Shostak writes:

“Trouble erupts when money is created out of “thin air.” Such money gives rise to consumption, which is not backed by production. It leads to an exchange of “nothing” for “something.” For instance, a counterfeiter prints twenty dollars. Since he did not secure this money through the production of goods, the counterfeiter, therefore, has obtained the twenty dollars by exchanging nothing for it. The counterfeiter uses the newly generated money to buy ten loaves of bread, which actually diverts real wealth—ten loaves of bread—from a potato farmer towards the counterfeiter.

Note that the diversion takes place by the counterfeiter paying a higher price for bread—he pays two dollars per loaf. (Previously the price stood at one dollar per loaf). Also, note that since the counterfeiter does not produce anything useful, he is engaged in nonproductive consumption and has obtained his consumption goods via wealth transfers from productive people.

The potato farmer is now denied the bread that he must have to sustain him while he produces potatoes. Obviously, this will impair the production of potatoes, as fewer potatoes will become available, which in turn undermines the baker's consumption. This, in turn, impairs his ability to produce. We can thus see that while productive consumption sustains wealth generators and promotes the expansion of wealth, nonproductive consumption leads to economic impoverishment.

Printing money by the central bank produces the same damaging effects as does counterfeit money. The undue expansion of money sets the platform for nonproductive consumption, which is an agent of economic destruction.”

I commend the entire article and recommend Frank Shostak as a good reference on sound economics. The Von Mises Institute is a mixed bag, in my opinion, but there are some solid economists there so if you are selective, you can learn a lot.

So, in conclusion, Stagnation, or arrested economic growth, is a feature, not a bug, of excessive money creation. And widespread price increases are a feature, not a bug, of excess money creation. We have to conclude that “Stagflation,” the combination of both arrested growth and price increases, is really a necessary outcome— a feature – of an inflationary policy.

Let’s draw a line there and see if there are any questions or comments.