An Inflation Primer

More than a few people have suggested to me that the problem of inflation could be resolved simply by eliminating the Federal Reserve. One even wrote, “In a true [free] market economy, financed by the government printing the money interest free, there would be no drive to create inflation and wage increases would be based on merit.”

There would be “no drive to create inflation?” That is more than a bit misleading. It is absurd. Why? Because it matters little *who* is creating money out of thin air. Whether a Federal Reserve creates new money with bookkeeping entries or the Treasury prints it is irrelevant.

The current scheme runs more or less like this: The federal government spends more money than it collects in taxes. Because it refuses to slash spending, it covers the deficit by borrowing money. It borrows money by selling interest-bearing bonds and notes. Some of that debt is bought by Americans in the form of savings bonds. Some is bought by other nations, such as China. If the Treasury Department can not find enough legitimate buyers for its debt (which is usually the case), the remaining debt is purchased by the Federal Reserve—a “bank” that was established in 1913.

The problem is that the Federal Reserve does not really have the huge amounts of money needed to buy the U.S. debt. What does it do? It essentially makes phony bookkeeping entries and accepts bonds from the U.S. government for the equivalent amount. The Treasury Department then says, “Oh, look, we just sold $500 billion in bonds to the Federal Reserve! We now have an additional $500 billion to pay our bills!” Everyone in government and the banking industry pretends that the books are in balance but, in fact, that is not the case. Why? Because the Federal Reserve did not have the $500 billion in the first place! Yet after the Federal Reserve “buys” the bonds with money it did not have, the Treasury Department has an extra $500 billion to spend. And it immediately does, writing checks to cover Social Security benefits, Medicaid, Medicare, military pay, missiles for the Defense Department, ammunition for the Department of Homeland Security, ObamaPhones for poor people, foreign aid, health insurance for Senators and Congressmen who can afford to pay for it themselves—and the Air Force One and Secret Service expenses for Obama’s many family vacations and golf trips.

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The government (that is, the taxpayer) pays interest to individuals, China, the Federal Reserve, and anyone else who bought savings bonds and Treasury notes. Some argue that we should eliminate federal interest payments by ending the sale of Treasury bonds—and simply print money whenever the government needs more! For some reason they believe this is a good idea: “Why pay interest at all? Just let the Treasury Department print money as it is needed!” That prompts the logical questions that they do not address: “If the government could simply print money as needed, why even bother having income taxes or any other taxes? If printing $1 trillion in new money to cover the deficit is harmless, why not just print $3.7 trillion every year to cover all government operations and eliminate taxes altogether? Why not print enough money to give every American $1 million and make everyone a millionaire so that no one ever has to work again?"

To argue that eliminating the Federal Reserve and simply printing money "interest free" as needed would eliminate inflation is absurd—and completely ignores the meaning of the word inflation. It is not the interest that causes price increases; it is the expansion of the money supply.

The reality is that printing money with no resulting price increases is possible *only if the amount of money being printed is limited to the replacement of worn out or destroyed currency, and restricted to the amount of economic growth.* If the supply of goods and services remains relatively constant, but the supply of money is increased, the result is a greater ratio of money to goods and services. There is more money is chasing after the same amount of goods and services. The *inescapable* result is price increases. But you cannot eliminate "inflation" (what most people call rising prices) simply by changing the identity of the person or agency expanding the money supply.

If there were no Federal Reserve and the Treasury Department simply printed money to cover federal deficits, we would still have price increases. Granted, the government would not be paying interest on money no longer borrowed from the Federal Reserve, but that means little. In fact, the nation's fiscal situation would almost certainly be *worse*—because the government would believe it could expand the money supply even more than it did *with* a Federal Reserve, thinking it could do so with no consequences! ("Hey, we don't even have to pay interest, so let's just raise the debt limit to $200 trillion!") Some people are reading too much Ellen Brown—an author who has little understanding of reality—if they believe printing money with reckless abandon is fine if only the "right people" do it. (Regrettably, a substantial number of Tea Party activists have fallen into the Ellen Brown camp. They rightfully argue that it would be good to eliminate the Federal Reserve; but they wrongfully argue that the government should still print money and expand the money supply.)

It is worth reviewing an inflation primer:

If an apple seller has 10 apples and 10 customers who each have $1 to spend, he could sell each apple for $1. (The total money supply is $10, the total consumer population is 10, and the total supply of goods and services is 10 apples.) If the money supply were increased to $15 by printing and passing out money and everyone had $1.50 to spend, the apple seller could obviously raise the price of his apples to $1.50. It is important to recognize that the apple price increase is *not* inflation; that price increase is the *result* of inflation. (Inflation is the artificial expansion, or "inflation," of the money supply. Just as a balloon is inflated, the money supply is inflated.)

The politicians blame businesses (such as apple sellers) for price increases because it gets them off the hook for the problem they themselves caused. But the apple seller did *not* cause the inflation. He merely *reacted* to it in a rational way. The apple price increase was caused by the government's inflation of the money supply. (If the population is 315 million rather than 10, and the apple is changed to every product and service available to those consumers, and the $10 money supply is changed to $15 trillion, the reality is the same. If that $15 trillion is suddenly increased to $20 trillion and everything else remains the same, prices will go up by $5 trillion.)

Yes, we could (and should) eliminate the Federal Reserve, but that would *not* eliminate inflation. What is necessary is to demand that the government *not* engage in deficit spending. *We must stop expanding the money supply.* That is what is needed for price stability.

Yes, some prices would still go up if the money supply were constant, but other prices would go down. For example, a hard frost in Florida could cause a shortage of oranges. That would result in more expensive orange juice, as consumers compete for a more limited supply of orange juice. But that is *not* inflation. It is merely an increase in the cost of orange juice—*not* an increase in the cost of *everything*. If a family must spend $5.00 more per week on orange juice, it must *necessarily* spend $5.00 per week *less* on something else—*because the family cannot print money and expand its own money supply.* What the family spends less on is irrelevant. The family's "money supply" remains constant.

The family may, of course, obtain more money if the breadwinner gets a salary increase. But a salary increase would (or should) be based on an increase in the worker's productivity. He (or she) may, for example, come up with a more efficient method of making the product at the factory where he works. That increased efficiency enables the company to pay him more, while at the same time lowering the price of its product—allowing it to outsell its competitors in the market. (The worker's income has increased, but it is paid for by increased productivity—*not* by printing money.) Absent government intervention in the economy, there would not only be no general price inflation, there would be a general *downward* trend in prices because of improved efficiencies, new inventions, and better manufacturing techniques—resulting from the ingenuity and productivity of workers and entrepreneurs.

The problem is the government, which promises more than it can deliver with its tax receipts. Thus, it engages in deficit spending. Deficit spending—since the creation of the Federal Reserve in 1913—requires an artificial expansion of the money supply to cover those deficits. If federal deficits were covered in total by *legitimate* borrowing (selling savings bonds to buyers with "real money," rather than to the Federal Reserve) there would be no need to print money. If the government needs an additional $1,000 and John Doe loans it to the government through the purchase of a savings bond, there is no expansion of the money supply. The $1,000 loaned to the government already existed; it was *not* created out of thin air by the Federal Reserve. The only change is that the government will be spending that $1,000 on something, rather than John Doe. The government may buy office furniture with the $1,000, while John Doe may have bought a new stereo system, but the money supply has *not* been expanded.

Unfortunately, the government's annual deficits are so monumental that the Treasury Department cannot find enough legitimate buyers for its bonds and notes. There are simply not enough John Does and Chinas lending money to the government. The government can entice buyers of its debt by offering to pay a higher interest rate (rates have gone up about one percent in the last year), but even that has not been enough. To make up the difference, the Treasury Department turns to the Federal Reserve, and chairman Ben Bernanke accommodates it by creating money out of thin air to buy what no one else is willing to buy. *That* is the problem, because the money supply is artificially expanded for Bernanke's bond purchases—currently about *$85 billion* per month.

The deficits are caused by politicians (of both parties) who do not have the ability or the nerve to raise taxes to pay for their campaign promises. But expanding the money supply is essentially a *hidden tax*, because it results in price increases that affect *everyone*—and they do not even know they are paying the tax! Even worse, the expanding money supply is a progressive tax that hurts the poor far more than anyone else, because they are less able to cope with rising prices. (A poor person can deal with an increase in the price of orange juice by drinking apple juice or water instead. But a poor person cannot deal with an increase in the price of *everything*—which is precisely what happens when the money supply is expanded.)

It has been repeated millions of times: there is no such thing as a free lunch. Yet some people still continue to believe there is. But do not be fooled. Changing the identity of the person or agency or that prints money to cover federal deficits is irrelevant. The solution is to stop printing money that is backed by nothing, *not* to pretend that printing it has no consequences just because one's intentions are good.

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