Volume Title: The Great Inflation: The Rebirth of Modern Central Banking

Volume Author/Editor: Michael D. Bordo and Athanasios Orphanides, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-006695-9, 978-0-226-06695-0 (cloth)

Volume URL: http://www.nber.org/books/bord08-1

Conference Date: September 25-27, 2008

Publication Date: June 2013

Chapter Title: Panel Session II, Understanding Inflation: Lessons of the Past for the Future

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Chapter URL: http://www.nber.org/chapters/c11174

Chapter pages in book: (p. 513 - 516)

Understanding Inflation
Lessons of the Past for the Future

Harold James

The study of inflation is always also a study of the ways in which inflation was understood. In the most dramatic cases of inflation that were not simply an immediate product of expensive military conflict producing an impetus for governments to devalue the currency, the inflationary process was propelled by intellectual arguments about why inflation (although it might produce some bad social consequences) was generally beneficial.

This was the case in the world's most famous hyper-inflation experience (though not quite the world's most extreme, which was post–World War II Hungary): Germany of the Weimar Republic. Representatives of the government explained that the inflation arose out of the circumstances of financing reparations payments and a trade deficit (rather than from the monetization of government debt) (Holtfrerich 1986). There were also many people who saw inflation as an interplay of organized interests, in which labor and employer organizations bid each other up (Feldman 1993). Inflation was thus simply a way of buying social peace in a politically precarious environment.

Not surprisingly, this interpretation became popular again during the postwar Great Inflation, in the 1970s. Again, a social science interpretation presented the inflation in Latin America (where it was generally higher), but also in the industrial countries, as a product of interest bargaining and of industrial corporatism, rather than as simply a monetary phenomenon. Again, it represented the power of organized interest groups, especially labor

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For acknowledgments, sources of research support, and disclosure of the author's material financial relationships, if any, please see http://www.nber.org/chapters/c11174.ack.

unions, and the accommodation of those interest groups in the political process (Hirsch and Goldthorpe 1978).

A narrowly economic interpretation of the causes of inflation has substantial attractions relative to the broader social science view, with its quasi-apologetic depiction of inflation. Presenting the inflation as a monetary phenomenon was the clearest intellectual path to ending the inflation, both in the 1920s and in the 1970s. The view that the German Great Inflation originated in central bank policy was at first associated with the Allies, and was bitterly resisted by most German decision makers. Indeed, the central bank president depicted his monetary accommodation as a patriotic duty, and boasted about the number of printing works and plate presses that his institution had set in motion to tackle a monetary shortage. In the 1970s, also, the monetary interpretation depended on the notion that the measurement of money stocks was both possible and significant.

In this regard, it is not clear that we have learned the lessons of the inflationary episodes, or whether those lessons and policy responses have been overlaid by other, more pressing problems. In 2008 we are in the remarkable position of fearing inflation and deflation simultaneously.

Forecasts of the future are currently very confusing. Many people, including central bank policymakers, fear the continuing deflation that emanates from the collapse of financial institutions and from the unwinding of debt exposure by banks scrambling to improve their capital rations. Other people, including some central bankers, are worried about the inflationary effect of worldwide stimulus packages and government deficits on a scale unprecedented in peacetime. Money is pouring into index-linked funds.

Perhaps there will be some new term coined to describe the confusing mixture of apparently opposite expectations of inflation and deflation: conflation.

Our confusion is not altogether new, and it is not simply a product of the financial crisis. We now recognize the 2000s as an era of loose money, thanks to a combination of central bank policy and the global flows of funds from emerging markets like China and from oil producers. But there were also deflation scares, especially in 2002, when there was both a major academic and a policy discussion. The academic debate at that time justified a new inclination on the part of central banks to push down interest rates.

Most surprisingly, the inability to differentiate between inflation and deflation also existed in the 1920s and 1930s (which still figures prominently as a laboratory of bizarre monetary experiments).

Most modern economic historians like to characterize the 1920s as a time when the gold standard orthodoxy imposed deflation on the whole world (Eichengreen 1992). But at the time, it was much more common to diagnose a credit inflation as banks cranked up their lending.

Even John Maynard Keynes, who emerged as the major critic of deflation during the Depression years of the early 1930s, began to see the 1920s as inflationary, not deflationary. In a self-critical account, he later wrote:

"Looking back in the light of fuller statistical information that was then available, I believe that while there was probably no material inflation up to the end of 1927, a genuine profit inflation developed some time between that date and the summer of 1929" (Keynes 1930, 2:190).

In the early 1930s, when no one would now claim that there was anything other than dire deflation, many of the critics of government spending programs warned about the threat of inflation. Ramsay MacDonald convinced an overwhelming majority of British voters that he should lead the country by waving the devalued paper currency of the German hyper-inflation during election rallies.

The uncertainty about inflation or deflation would be only a footnote to the history of economic thinking were it not that as a result of the experiences of the past forty years, inflation has become the key to the way we think about monetary policy.

After the collapse of the fixed exchange rate regime in the early 1970s, the previous anchors of monetary policy disappeared. By the middle of the 1970s, some central banks began to argue formally for a replacement of fixed exchange rates as an anchor for stability by a targeting system for the growth of money. But then they found it hard to define what measure of money they wanted to target.

The disillusion with monetary policy produced a new interest in targeting inflation rather than monetary growth. In some cases, inflation targeting grew out of an intellectual conviction that it represented a superior way of dealing with the problem of inflationary expectations. New Zealand in 1990 and Canada in 1991 adopted this approach (Bernanke 1999).

First in academic life and then in policymaking, Ben Bernanke has been an academic pioneer of the concept. He started off by recognizing the novelty of the approach, stating in 2003 that many Americans considered inflation targeting "foreign, impenetrable, and possibly slightly subversive."

Some of the most spectacular conversions to inflation targeting occurred in the aftermath of currency crises, as previously fixed exchange rates disintegrated and policymakers looked for an alternative tool to achieve stability. That was the British experience, and the Bank of England can rightly regard itself as a pioneer of inflation targeting. The adoption in October 1992, as the logical response after sterling was forced out of the European Monetary System (EMS). Sweden, which experienced a similar currency crisis, also chose the same response in January 1993.

But just as monetarism in its classic form of the 1970s was frustrated and ultimately defeated by the inability to say precisely what money was and consequently how it might be measured, we are helpless in the face of all kinds of different measures of inflation. Should we include fluctuating seasonal food prices, or energy prices that move in unpredictable ways, or mortgage payments?

One of the most intense theoretical disputes over recent years was the extent to which central banks should attempt to correct or limit asset prices bubbles when there was no corresponding rise in the general level of inflation. Asset price rises lead to a general increase in purchasing power, because many asset-holders will use them as securities against which to borrow. Many Europeans tried to argue in recent years for the inclusion of some element to take asset price developments into account, while this approach was largely resisted by American policymakers and academics.

The problem is that asset prices and consumer price inflation may move in quite different directions, as they did in the 2000s, and that following both would produce inconsistent policy recommendations. Devising a formula to derive a rule on monetary policy would involve a nearly impossible exercise in weighting both factors. Central banks ran the risk as a result of no longer appearing to follow a clearly formulated policy guideline, and they might well lose credibility. But it was the search for a reliable rule, not susceptible to political interference, that had produced the desire for the inflation target in the first place.

The inflation targeting approach to monetary policymaking is in consequence facing its own moment of truth: the acknowledgment that there is an element of discretion in the application of rules, and that central banking is an art as well as a science.

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