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What Has Government Done to Our Money?

Murray N. Rothbard

III. Government Meddling With Money

2. The Economic Effects of Inflation

To gauge the economic effects of inflation, let us see what happens when a group of counterfeiters set about their work. Suppose the economy has a supply of 10,000 gold ounces, and counterfeiters, so cunning that they cannot be detected, pump in 2000 "ounces" more. What will be the consequences? First, there will be a clear gain to the counterfeiters. They take the newly-created money and use it to buy goods and services. In the words of the famous *New Yorker* cartoon, showing a group of counterfeiters in sober contemplation of their handiwork: "Retail spending is about to get a needed shot in the arm." Precisely. Local spending, indeed, *does* get a shot in the arm. The new money works its way, step by step, throughout the economic system. As the new money spreads, it bids prices up—as we have seen, new money can only dilute the effectiveness of each dollar. But this dilution takes time and is therefore uneven; in the meantime, some people gain and other people lose. In short, the counterfeiters and their local retailers have found their incomes increased before any rise in the prices of the things they buy. But, on the other hand, people in remote areas of the economy, who have not yet received the new money, find their buying prices rising before their incomes. Retailers at the other end of the country, for example, will suffer losses. The first receivers of the new money gain most, and at the expense of the latest receivers.

Inflation, then, confers no general social benefit; instead, it redistributes the wealth in favor of the first-comers and at the expense of the laggards in the race. And inflation is, in effect, a race—to see who can get the new money earliest. The latecomers—the ones stuck with the loss—are often called the "fixed income groups." Ministers, teachers, people on salaries, lag notoriously behind other groups in acquiring the new money. Particular sufferers will be those depending on fixed money contracts—contracts made in the days before the inflationary rise in prices. Life insurance beneficiaries and annuitants, retired persons living off pensions, landlords with long term leases, bondholders and other creditors, those holding cash, all will bear the brunt of the inflation. They will be the ones who are "taxed." [2]

Inflation has other disastrous effects. It distorts that keystone of our economy: business calculation. Since prices do not all change uniformly and at the same speed, it becomes very difficult for business to separate the lasting from the transitional, and gauge truly the demands of consumers or the cost of their operations. For example, accounting practice enters the "cost" of an asset at the amount the business has paid for it. But if inflation intervenes, the cost of replacing the asset when it wears out will be far greater than that recorded on the books. As a result, business accounting will seriously overstate their profits during inflation—and may even consume capital while presumably increasing their investments. [3] Similarly, stock holders and real estate holders will acquire capital gains during an inflation that are not really "gains" at all. But they may spend part of these gains without realizing that they are thereby consuming their original capital.

By creating illusory profits and distorting economic calculation, inflation will suspend the free market's penalizing of inefficient, and rewarding of efficient, firms. Almost all firms will seemingly prosper. The general atmosphere of a "sellers' market" will lead to a decline in the quality of goods and of service to consumers, since consumers often resist price increases less when they occur in the form of downgrading of quality. [4] The quality of work will decline in an inflation for a more subtle reason: people become enamored of "get-rich-quick" schemes, seemingly within their grasp in an era of ever-rising prices, and often scorn sober effort. Inflation also penalizes thrift and encourages debt, for any sum of money loaned will be repaid in dollars of lower

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purchasing power than when originally received. The incentive, then, is to borrow and repay later rather than save and lend. Inflation, therefore, lowers the general standard of living in the very course of creating a tinsel atmosphere of "prosperity."

Fortunately, inflation cannot go on forever. For eventually people wake up to this form of taxation; they wake up to the continual shrinkage in the purchasing power of their dollar.

At first, when prices rise, people say: "Well, this is abnormal, the product of some emergency. I will postpone my purchases and wait until prices go back down." This is the common attitude during the first phase of an inflation. This notion moderates the price rise itself, and conceals the inflation further, since the demand for money is thereby increased. But, as inflation proceeds, people begin to realize that prices are going up perpetually as a result of perpetual inflation. Now people will say: "I will buy now, though prices are 'high,' because if I wait, prices will go up still further." As a result, the demand for money now falls and prices go up *more*, proportionately, than the increase in the money supply. At this point, the government is often called upon to "relieve the money shortage" caused by the accelerated price rise, and it inflates even faster. Soon, the country reaches the stage of the "crack-up boom," when people say: "I must buy anything now—anything to get rid of money which depreciates on my hands." The supply of money skyrockets, the demand plummets, and prices rise astronomically. Production falls sharply, as people spend more and more of their time finding ways to get rid of their money. The monetary system has, in effect, broken down completely, and the economy reverts to other moneys, if they are attainable—other metal, foreign currencies if this is a one-country inflation, or even a return to barter conditions. The monetary system has broken down under the impact of inflation.

This condition of *hyper-inflation* is familiar historically in the *assignats* of the French Revolution, the Continentals of the American Revolution, and especially the German crisis of 1923, and the Chinese and other currencies after World War II. [5]

A final indictment of inflation is that whenever the newly issued money is first used as loans to business, inflation causes the dread "business cycle." This silent but deadly process, undetected for generations, works as follows: new money is issued by the banking system, under the aegis of government, and loaned to business. To businessmen, the new funds seem to be genuine investments, but these funds do not, like free market investments, arise from voluntary savings. The new money is invested by businessmen in various projects, and paid out to workers and other factors as higher wages and prices. As the new money filters down to the whole economy, and the people tend to reestablish their old voluntary consumption/saving proportions. In short, if people wish to save and invest about 20% of their incomes and consume the rest, new bank money loaned to business at first makes the saving proportion look higher. When the new money seeps down to the public, it reestablishes its old 20-80 proportion, and many investments are now revealed to be wasteful. Liquidation of the wasteful investments of the inflationary boom constitutes the *depression* phase of the business cycle. [6]

[2] It has become fashionable to scoff at the concern displayed by "conservatives" for the "widows and orphans" hurt by inflation. And yet this is precisely one of the chief problems that must be faced. Is it really "progressive" to rob widows and orphans and to use the proceeds to subsidize farmers and armament workers?

[3] This error will be greatest in those firms with the oldest equipment, and in the most heavily capitalized industries. An undue number of firms, therefore, will pour into these industries during an inflation. for further discussion of this accounting|cost error, see W.T. Baxter, "The Accountant's Contribution to the Trade Cycle," *Economica* (May, 1955), pp. 99-112.

[4] In these days of rapt attention to "cost-of-living indexes" (e.g., escalator-wage contracts) there is strong incentive to increase prices in such a way that the change will not be revealed in the index.

[5] On the German example, see Costantino Bresciani-Turroni, *The Economics of Inflation* (London: George Allen and Unwin, Ltd., 1937).

[6] For a further discussion, see Murray N. Rothbard, *America's Great Depression* (Princeton: D. Van Nostrand Co., 1963), Part I.

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