THE DEFINITION OF INFLATION ACCORDING TO MISES: IMPLICATIONS FOR THE DEBATE ON FREE BANKING

NICOLÁS CACHANOSKY*

Introduction

THE DISCUSSION OF WHAT IS and what is not inflation has become important among the Austrian economists in their debate regarding free banking with fractional reserves versus banking with 100-percent reserve. That such an old and important discussion has not yet reached a consensus is interesting and suggests that there may be a problem or ambiguity around this concept.

Many Austrians also turn to the writings of Ludwig von Mises to find out what he himself considered to be inflation. The main intention is to find out if, in either system, free banking with fractional reserves or a 100-percent reserve, there could be cases of free market inflation. In particular, does any change in the quantity of money (in the broad sense) imply inflation? Is it inflationary for the banking system to expand the quantity of fiduciary media even when there has been an increase in the demand to hold money in the broader sense?

If this is so, then a fractional reserve system will inherently generate inflation. Instead, if only increments in the quantity of money above the market demand are inflation, then the free banking proposal does not imply implicit inflationary misallocations.

*Nicolás Cachanosky (ncachanosky@suffolk.edu) is Graduate Student of Economics at Suffolk University. The author acknowledges helpful feedback and comments from Adrián O. Ravier, Ivo A. Sarjanovic, Lawrence H. White, Gabriel Zanotti, and an anonymous referee. The usual caveats apply.

Cite this article as: Nicolás Cachanosky, "The Definition of Inflation According to Mises: Implications for the Free Banking Debate," *Libertarian Papers* 1, 43 (2009). Online at: libertarianpapers.org.

There seems to be a lack of agreement among Austrians on what Mises thought about what is and what is not inflation. The present article does not deal with the fractional reserve controversy or with what we should consider to be inflation, but only with an interpretation of what Mises himself considered as inflation, with the hope that it will help to clarify what the Austrian dean thought of this term. The article shows the free banking versus 100-percent debate can do without the problem of inflation when defined as Mises does. This simplifies the complexity of the debate by doing away with a difficult concept. The debate can focus on the different effects of changes in money supply or demand in each banking system without the need of defining the presence or absence of inflation.

I will be referring mainly to two specific chapters by Mises where he deals expressly with the concept of "inflation": 1) Chapter VII.7 from *Theory of Money and Credit* and 2) his sub-section in Chapter XVII.6 from *Human Action*. In all the following quotations, emphases in italics have been added.

Mises on Inflation

An Interpretation

The first point we should consider is that Mises remarks that the term inflation is not a praxeological term coming from economics, but an idea that comes from political or popular use. For this reason, the word inflation lacks the accuracy expected to be found in a theoretical term, becoming a tricky and sloppy concept (Mises, 1949 [1996], p. 442):

> The notions of inflation and deflation are not praxeological concepts. *They were not created by economists, but by the mundane speech of the public and of politicians.*

This first consideration helps to explain why it has been difficult to reach a common agreement even among Austrians; this inaccuracy of origin creates different opinions regarding the same word. It is clear that, when we speak of inflation, we are talking about a specific phenomenon, but the political or popular definition, because it is not accurate enough, does not clearly specify when there is and when there is not inflation. Furthermore, Mises (1949 [1996], p. 442) mentions that the concept of inflation is also built on the ideas of stable purchasing power and neutrality:

> They implied the popular fallacy that there is such a thing as neutral money or money of stable purchasing power and that sound money should be neutral and stable in purchasing power. *From this point of view the term inflation was applied to signify cash-induced changes resulting in a*

> *drop in purchasing power*, and the term deflation to signify cash-induced changes resulting in a rise in purchasing power.

Then, following the common idea of inflation, Mises (1912, [1981], p. 272) tries to develop a more precise definition of inflation:

> In theoretical investigation there *is only one meaning that can rationally be attached to the expression Inflation:* an increase in the quantity of money (in the broader sense of the term, so as to include fiduciary media as well), *that is not offset by a corresponding increase in the need for money* (again in the broader sense of the term), so that a fall in the objective exchange-value of money must occur. Again, Deflation (or Restriction, or Contraction) signifies: a diminution of the quantity of money (in the broader sense) *which is not offset by a corresponding diminution of the demand for money* (in the broader sense), so that an increase in the objective exchange-value of money must occur.

In *The Theory of Money and Credit* he makes the same comment. What Mises is trying to say is the following: If we want to keep or use the political or popular definition of inflation, so that it will have some kind of utility or mean something more concrete, it is necessary to restrict it by arguing that inflation should be understood as the "increase in the quantity of money (in the broad sense) above the demand of money by the market" (and the other way around for deflation). However, Mises (1912 [1981], p. 272) immediately continues as follows:

> If we so define these concepts, *it follows that either inflation or deflation is constantly going on*, for a situation in which the objective exchange-value of money did not alter could hardly ever exist for very long.

These two passages are from the same paragraph and may be confusing. Here is where we have to look beyond Mises' words and try to interpret what he is trying to say. Mises says that the concept of inflation does not come from economics, but from a political or popular origin when certain changes in the level of prices became so important that they could not be ignored and were popularly called inflation. Given that, in Mises' view, the market is not in equilibrium and money is by definition not neutral, it follows that this definition will allow us to conclude that there will always be inflation or deflation; however, if this is the case, then this definition of inflation encompasses all changes in price, rendering it in someway meaningless. The word inflation, then, can be descriptive, but in theoretical terms, it does not add anything new. What the layman does not grasp, according to Mises (1949 [1996], p. 423), is that there are always movements of prices and that the political or popular definition does not leave anything outside its own meaning:

> However, those applying these terms *are not aware* of the fact that *purchasing power never remains unchanged* and that consequently there is always either inflation or deflation.

Under this situation, Mises suggests that a more appropriate definition of inflation would be that of changes above the market demand of money, although he does not seem to find this definition so useful either. It might be feasible to look for a totally different definition, but it is most likely that Mises would have preferred to look for a different word in that case, and when restricting the idea of inflation, he wanted to preserve the same popular or political line of interpretation to avoid more confusion.

When he says that inflation and deflation would be constantly present, he is not referring to inflation according to his own rational theoretical definition, but any changes in the purchasing power of money. Politicians or individuals should conclude that there will always be inflation or deflation according to their own definition, but they seldom do so. Mises (1949 [1996], p. 423) says that a politician or individual sees inflation only when there are big changes:

> They ignore these necessarily perpetual fluctuations as far as they are only small and inconspicuous, *and reserve the use of the terms to big changes in purchasing power*. Since the question at what point a change in purchasing power begins to deserve being called big *depends on personal relevance judgments, it becomes manifest that inflation and deflation are terms lacking the categorial precision required for praxeological, economic, and catallactic concepts.*

Mises (1912 [1981], pp. 272–73) concludes that economics could even do without the term inflation because it is based on political considerations and not on theoretical grounds:

> But once the economist has acknowledged that it is not entirely nonsensical to use the expressions Inflation and Deflation to indicate such variations in the quantity of money as evoke *big* changes in the objective exchange-value of money, *he must renounce the employment of these expressions in pure theory. For the point at which a change in the exchange-ratio begins to deserve to be called big is a question for political judgement, not for scientific investigation.*

Here Mises is making an argument similar to the argument he made about index numbers as a measure of purchasing power.[1] In pure theory,

[1]Mises (1912 [1981] p. 223): "The practical use of all these calculations for certain purposes is beyond doubt; they have proved their worth in quite recent events. But we should beware of demanding more from tem than they are able to perform." Mises distinguishes between a practical use of, in this case, an index and the development of economic theory.

index numbers are of no use and have a very uncertain meaning; but when studying historical events or looking from the politician's point of view, they can be very useful (Mises, 1949 [1996], p. 423):

> Their application is appropriate for history and politics. Catallactics is free to resort to them *only when applying its theorems to the interpretation of events of economic history and of political programs.* Moreover, it is very expedient even in rigid catallactic disquisitions to make use of these two terms whenever *no misinterpretation can possibly result* and pedantic heaviness of expression can be avoided.

But immediately, Mises (1946 [1996], p. 423) says the following:

> But it is necessary never to forget that *all that catallactics says with regard to inflation and deflation*—i.e., big cash-induced changes in purchasing power—is valid *also* with regard to small changes, although, of course, the *consequences of smaller changes are less conspicuous than those of big changes.*

This paragraph may again be confusing, but the word "also" helps the reader to understand it: "We should not forget that all that economics says about inflation is *also* present in *another* phenomenon, which is that of small changes in the quantity of money". Then, small changes and big changes in the quantity of money cause the same effects, even if popular discussion reserves the use of the word inflation for big changes. However, Mises remarks that there is no objective way to define the limit (big changes), and that is why he suggests inflation as "an increase in the quantity of money above the market demand of money." Note that, under Mises' suggested definition, not every increase in the quantity of money is inflation, only increases that exceed market demand.

In these chapters, Mises is dealing with the problem of giving a specific meaning to the popular and commonly used term inflation. On the other hand, given that for Mises money is not neutral by definition and prices are not in equilibrium, every change in the quantity of money always has effects on relative prices, but not every change in relative prices is due to inflation. He saves the term inflation for cases where the quantity of money is increasing above the market demand for money. Both small and big changes in the quantity of money have effects on relative prices, and there is a drop in the purchasing power of money (more precisely, a bigger drop in the purchasing power than the market would otherwise have brought about.)

It seems worth to mention that in a lecture given at The Foundation for Economic Education in 1951, printed in *The Free Market and Its Enemies*, Mises (1952 [2004], p. 43) still remarks the terminological problem around the word inflation:

> One of the problems with which an economist must struggle is the fact that the terminology of business was developed prior to the development of economic theory, *so that the language is not particularly appropriate for dealing with economic problems*. One such case, which has resulted in real difficulty, is that of the money market.

In addition, Mises (1952 [2004], p. 44) again referred to inflation as "an increase in the quantity of money without a corresponding increase in the demand for money, i.e., for cash holdings."

Comments

We may make three final comments on this interpretation of Mises and inflation. First, this definition of inflation as an expansion above the market demand of money is compatible with Mises' and the Austrian theory of money in the sense that money is also a commodity. It is hard to think that Mises would have said that there is inflation in a situation where, for example, several individuals decide to convert part of their gold ornaments into coins, even though this would have introduced more money into the market and changes in relative prices. In this situation, the individuals in question have increased their demand to hold money, so the increase in the quantity of money does not exceed the increase in the demand for money. If every increase in money is inflationary, then we would have to consider the emergence of money as explained by Carl Menger's theory to be inflationary as well. As money is a commodity with the characteristic of being widely accepted, any commodity can be money in different times and places. To be more precise, commodities can be more or less *money* according to their *degree* of acceptance.

Second, the term inflation comes loaded with many negative connotations, but in the scope of pure theory, these negative connotations should not apply. The term purchasing power is neither good nor bad, but the word inflation is interpreted as a bad thing. This can prejudice the analysis. If, for example, all changes in the quantity of money are interpreted as inflationary independently of what happens with the demand of money, and by definition inflation is something bad, then the conclusion is predetermined that we should prevent the quantity of money from ever changing.

Third, if Mises is right in saying that the economy can do without the term inflation, given that the term could be sloppy and tricky, it could needlessly complicate the free banking versus 100-percent reserve debate. The discussion should be able to do without the term inflation as its ambiguity and connotations bring more confusion than clarity to the discussion. The ambiguity of the term inflation is also why Mises differentiates in the same chapters between inflation/deflation as market phenomena and inflationism/deflationism as the monetary policy aiming for big changes in the purchasing power of money.

Conclusions

Although Mises was quite sharp in mentioning this non-praxeological characteristic of inflation, he could have been clearer on this point. For example, he could have emphasized more plainly in these chapters that endogenous or market changes in the quantity of money affect relative prices because money is not neutral, as opposed to the idea that inflation is marked by a large decrease in the purchasing power of money. In addition, in Human Action, he does not mention the only rational definition of inflation that appears in his Theory of Money and Credit, which marks a difference between these two chapters. Both effects (changes in relative prices and a decrease in the purchasing power of money) happen together when there is inflation, but not because they are exactly the same concept.

Economic theory should be very careful in the use of the terms inflation and deflation since their specific limits are very difficult to stipulate and more difficult to measure; that is why Mises preferred to use the words inflationism and deflationism to refer to policies aiming to increase and decrease the quantity of money. The debate between free banking and 100-percent reserves should also be very careful on its use of the term inflation, as this may add more confusion than clarity. However, the concept of inflation, like the closely related concepts of index number and level of prices, can certainly be of use for pragmatic issues or historical investigation even though they are theoretically imprecise. These two fields, pragmatic and historical investigation on one side and pure theory on the other, should not be confused.

References

von Mises, L. (1949). *Human Action. A Treatise on Economics* (1996 ed.). New York: The Foundation for Economic Education.

———. (1952). *The Free Market and Its Enemies: Pseudo-Science, Socialism, and Inflation* (2004 ed.). New York: The Foundation for Economic Education.

———. (1912). *The Theory of Money and Credit* (1981 ed.). (H. E. Batson, Trans.) Indianapolis: Liberty Fund.