The Essence of Inflation

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Goods & Services

Humans have inhabited the planet Earth for many thousands of years. A significant determinant of the speed of commercial growth during this period has been the efficiency of the financial system that supported the humans trading their goods and services with each other. Initially, humans used the basic two-party barter process.

In the next evolutionary phase in the human financial system, barter slowly declined as it gave way to coins made from scarce metals. For the many humans participating in commerce, these coins created an expectation of more liquidity and a more predictable value than that they had experienced using barter.

Along with this increase in the efficiency of trade, the rate of commercial growth accelerated as it expanded into new markets to buy and sell goods and services using these supply constrained mediums of exchange. In the case of gold as the medium of exchange, its stable value came from a combination of its indestructibility and the difficulty of finding a lot more of it in the ground.

After the 1540 invention of the printing press, money printed on paper became another medium of exchange. As would be expected, the use of traditional barter continued its decline. The use of this new paper money increased significantly due largely to its weight being much so lighter than gold coins or silver coins. At various times during the following 400-year period, some governments issued paper money for which they promised to exchange for their physical gold. When the currency or debt allowed the holder to require the ability to exchange the paper for gold, it was and still is known as being on the Gold Standard. To this day, the generic term Gold Standard usually means the "best of its kind."

Also during this lengthy period, some governments have printed much more gold-backed paper money than the gold that they held for its exchange. When the holders of this paper recognized that their paper money might not be exchanged for gold, they were inclined to sell it and buy other gold-backed paper money that was thought to be safer. When this happened, the paper money eventually declined in value and everything else's price increased if the price was stated in terms of the declining in value paper money. Such an increase in the price of goods and services as measured by units of a medium of exchange is known as inflation. Whenever there has been an increase in the supply of the medium of exchange, inflation has been the most likely result.

As we leave this section, it would be remise to not include how modern day banks can also create new money and increase its supply available to acquire more goods and services than otherwise. As an example, when a depositor puts money in a bank, the bank can lend most of that that money to a borrower. At that moment, the original depositor's deposit remains at his bank and is available for withdrawal to buy things. The borrower has into his bank also deposited the loan proceeds that are also available for withdrawal to buy things. These two deposit accounts that can be spent on goods and services, are more likely to increase the demand for goods and services than had there been only the first depositor's account. This phenomenon is called fractional banking and it is backbone of how modern banks can earn larger profit margins. It is also likely to be not understood by the majority of American citizens.

American Dollar Inflation

From a sparsely populated America in 1635 until the present, the medium of exchange used in America evolved from occasional Barter to Coins to Paper Money, some of which was backed by Gold and some was not.

These 400-years can be divided into three periods:

1. Between 1635 and 1933, American dollars were sometimes ON and sometimes OFF the Gold Standard.
2. Between 1933 and 1971, American dollars owned by its citizens were OFF the Gold Standard and American dollars owned by various foreign governments were ON the Gold Standard.
3. Between 1971 and 2022, American dollars owned by everyone were OFF the Gold Standard

By combining third-party estimates for the early periods and more accurate government calculations for later periods, the annual inflation rate in America during each of these three periods can be calculated. Since 1933, the cumulative inflation rate was 2,151% and the annual inflation rate was 3.56%. This indicates that an America dollar in 1933 could buy approximately 21 times the quantity of the same goods and services that it could buy in 2022. (1)

TABLE 1

Period	Cumulative Rate of Inflation	Annual Inflation Rate	Years
1635 - 1933	56.6%	0.2%	298
1933 - 2022	2,151.0%	3.6%	89
1933 - 1971	211.5%	3.0%	38
1971 - 2022	622.6%	4.0%	51

During each of these two periods, before 1933 and after 1933, there is a significant difference in the rate of inflation. If viewed probabilistically, the mathematical conclusion is that this disparity was highly unlikely to have happened by chance alone.

Important Questions

The above data leads to the following three important questions for which the author has focused on providing answers without bias:

1. Who likes inflation?

Answer:

a) Anyone who borrows money and believes that they can repay this debt and interest with money that cannot purchase the same amount of goods and services as it did when they borrowed the dollars.
b) Governments that print more money or issue a lot more of its debt to spend on its citizens rather than taking the political risk of increasing taxes on its citizens.
c) Real estate and stock purchasers who use mostly debt or leverage to purchase these assets;
d) Corporations expanding their business capital by borrowing money and receiving income tax deductions rather than sell stock and make the business more stable and safer for employees.
e) Governments that can tax a citizen's income that is caused by inflation. When a citizen buys an asset and then sells it for profit after a period of high inflation, much of the taxable capital gain income is likely the result of inflation. Also, when a worker receives a pay raise to offset the effects of prior inflation, the worker's income tax paid to the government also increases the government's income.
f) Investors in businesses whose profits and asset values benefit from inflation.
g) The many millions of people whose current employment depends on more inflation.

2. Who does NOT like inflation?

Answer:

a) People that deposit their money in a bank or accept a fixed annual dollar return over a long period of time. Retired workers are a large part of this group
b) People who do NOT invest in businesses whose profits and asset values benefit from inflation.
c) People who keep their money under the mattress or buried in the backyard.

3. What happened in 1933 and 1971 that caused a significant increase in American dollar inflation?

Answer:

The two events were:

a. In 1933, America's willingness to allow holders of its paper money to exchange their paper money for a fixed weight of America's physical gold held as reserves to support the value of the US Dollar began to erode during the early years of the failing global economy known as the Great Depression of the 1930's.

   In response, President Roosevelt on April 5, 1933 signed Executive Order #6102 that forced American citizens, except for dentists and a few others, to sell their gold to the Government for $20.67 per ounce or be subject to a "$10,000 fine or 10-years imprisonment or both." The U.S. Government did however continue to allow various specific governments to continue to exchange their American gold-backed dollars for America's physical gold.

b. In 1971, the American government feared that other governments' concern about America's rising federal deficit and concerns about the stability of the American dollar might accelerate these governments' desire to exchange their American dollars into America's physical gold. America's President Richard Nixon rather abruptly announced during a nationally televised speech at 9 p.m. on August 15, 1971 that he was taking the American dollar completely off the Gold Standard.

   This event ended the exchanging of America's dollars for America's gold. It also ended the quasi gold-related global currency management system that was created at the international Bretton Woods Conference held in July of 1944 at Bretton Woods, New Hampshire. Some people still refer to this new post-1971 economic policy as "going off the Gold Standard" and some refer to it simply as "after the end of Bretton Woods."

The Future

At the "end of Bretton Woods" moment in 1971, America's "Inflation Era" began and continues largely unobstructed.

Whether or not using American dollars backed by anything with a stable supply could control the rate of inflation and reduce the social costs and inequities of ongoing inflation remains a debate that is not yet at the center of public attention.

Someday, when either the income gap or the wealth gap between rich and poor is large enough, it will be the center of public attention.

END NOTE
(1) www.in2013dollars.com

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