Whiskey and Gunpowder
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Greg's note: Today Fred Sheehan presents a novel discussion on inflation. Interestingly, he goes through the article without actually referencing prices. Although he may not claim it himself, I feel that he has laid out what amounts to moral explanation of inflation – and its results. Please read on and send any responses to your immoral editor here: greg@whiskeyandgunpowder.com

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Inflating the Substitution Effect

Inflation is reported -- and thought of -- as the percentage increase in prices or the declining value of money. This is visible. But it is only one side of the story. What follows is an exploration of inflation without reference to prices.

On June 28, 1978, Federal Reserve Governor Henry C. Wallich addressed the graduating class at Fordham Graduate School of Business in New York. Inflation was on everyone's mind and Wallich was forthcoming. "Inflation," he informed the young and idealistic graduates, "is a means by which the strong can more effectively exploit the weak. The strategically positioned and well-organized can gain at the expense of the unorganized and the aged."

How is this so? Wallich explained inflation, "is technically an economic problem. I mean the breakdown in our standards of measuring economic values, as a consequence of inflation." The strong are smart enough to understand that inflation "introduces an element of deceit into most of our economic dealings." Contracts are no longer made to "be kept in terms of constant values," but one party understands this better than the other. Contracts during a period of inflation are made with monetary terms "unpredictably shifting measures of weight, time or space…"

General Mills understands this. The maker of Wheaties and Lucky Charms has passed on the rising cost of grains without raising retail prices. It tried to increase prices in early 2005, and sales of some cereals fell by 5%. This time around, it is attempting if not a deceitful maneuver, one that is clever. According to the Minneapolis StarTribune.com: "Customers will actually see lower prices per box, but the boxes will be smaller, so the effect is a price increase of a few percent." The price increase is murky, but evident.

Wallich grew up in Germany and survived the 1923 hyperinflation (excellent training for any central banker). In his adopted country, Wallich watched the deterioration of product quality during the inflationary 1970s. A 1966 Lou Harris Poll found that 75% of respondents thought American goods were of "good" or "excellent" quality. By 1971, this had fallen to 47%. In 1977, 27% would not buy the products they made. And so it is today. In May, *The New York Times* submitted a pier-front report from Madeira Beach, Fla., the "grouper capital of the world." Its reporter found that "seven of 24 [restaurants] were passing off cheaper imported fish -- tilapia…hake…painted sweetlips [and other fish with names too gruesome to mention] -- as grouper."

Fishing restrictions are one problem, but more so are higher fuel costs and condominium development that is "taking over the waterfront." Here we find the nexus of higher energy costs, cheap money, bad food, and exploitation. Since unlimited credit gave every Florida fisherman the wherewithal to buy a waterfront condo, there is no place to moor a boat. This is not just a local problem. The Holbrook Community Foundation in Harpswell, Maine, is raising money to save Holbrook's Wharf, a fishing pier for decades. The foundation was "fearful the property would be sold and converted to what locals call a 'McMansion.'" This is not an idle fear. The *Portland Press Herald* reports: "Just 20 miles of Maine's 5,300-mile coastline is classified as 'working waterfront,' and much of that is vulnerable to development that could limit access further." From personal observation, poorly constructed condominium projects have replaced former Maine fishing villages that fade from memory.

Wallich warned that inflation substitutes government for liberty: "Inflation becomes a means of exploiting labor's money illusion." Among the winners, from the mouth of this public servant, is government. "It allows the politician to make promises that cannot be met in real terms, because, as the government overspends trying to keep those promises, the value of the benefits it delivers shrinks." This creates a "diminishing ability of households to provide privately for their future…One may indeed ask whether it is not an essential attribute of a civilized society to be able to make that kind of provision for the future." Wallich went on to emphasize that "the increasing uncertainty in providing privately for the future pushes people who are seeking security toward the government." So we have the public panic concerning Social Security and health insurance today.

Wallich continued. Inflation "creates a vacuum in the private sector into which the government moves." Today, the tendency is to expect government to solve the health insurance dilemma. Yet the visible effect of greater government involvement in health care has been higher costs and a suffocating bureaucracy of paperwork. The Federal Reserve governor worried that the consequences of inflation would be "a shift also in the third dimension, away from democracy and toward authoritarianism." Wallich's question was more than theoretical. The German, post-World War I hyperinflation wiped out the middle class, the consequences of which were not Arcadian.

(Wallich was no latecomer to this view. He served on President Eisenhower's Council of Economic Advisers. After stepping down, and having seen a stream of opportunist Ivy League economics professors convince Washington that economic "growth" was America's patriotic duty, Wallich wrote a short book. *The Cost of Freedom* recognized growth as a very good thing, but not when government boosts the growth. Such a "forced draft economy" compromises individual freedom.)

Authoritarianism can be invisible. The government's employment of the substitution effect in the consumer price index is an affront to the people it represents. The clandestine nature of such maneuvers should not be overstated. The unread Boskin Commission Report makes its methodology clear: "Pork and beef are two separate CPI item categories. If the price of pork increases while the price of beef does not, consumers might shift away from pork to beef. The [CPI] is designed to account for this type of consumer substitution between CPI item categories."

The American people have been forewarned of this duplicity. Yet it is still impossible for a nongovernment employee to calculate the effect of substitution. The Bureau of Labor Statistics does not reveal which items are jettisoned. For all we know, the government may be substituting peanut butter cups for pork. In a tangential sense, it already is. The biggest single cost in raising a pig for slaughter is feed. Corn, part of the traditional meal, is too expensive. According to *The Wall Street Journal* , pigs now feast on a diet of trail mix, licorice, peanut butter cups, cheese curls, Cocoa Puffs, and Tater Tots.

Such substitutions as beef for pork are crystal clear compared with another Boskin Commission CPI-shrinking maneuver: "Just as consumers change the goods they purchase in response to changes in relative prices, as in the beef and [pork] example, so do they change the location where they make their purchases. The opening of a new discount store outlet may give consumers the opportunity to purchase at a lower price than before." The consumer may -- and certainly does, in the government's calculation -- choose to drive an extra 10 miles to save 30 cents for a gallon of milk (this lower price no doubt programmed into the CPI), but the time wasted is not an explicit cost. Nor the cost of gas.

The diminishing dignity of the American people cannot be calculated. Kathleen Parker wrote in the *Chicago Tribune* about call center hell (not her description). She spoke to someone in India "named Kapil pretending to be Karen…Anglicizing names is one of the tricks of the trade these days as more and more customer services are outsourced to other countries." History may not repeat, but Parker describes what Wallich observed in the 1920s and the 1970s. Once again, the strong are smart enough to understand that inflation "introduces an element of deceit into most of our economic dealings." Contracts are no longer made to "be kept in terms of constant values" but one party understands this better than the other. Here is a concrete example of Wallich's abstract description of monetary inflation as an "unpredictably shifting [measure] of weight, time or space…"

Parker goes on: "The corporate insult of hiring foreigners is compounded by the pandering of passive-aggressive non-Americans. Between robots and foreign operators -- and the powerlessness most consumers feel -- American business has robbed its citizen-customers of their dignity." Hopelessness also demeans the shopper who stares at the butcher's counter in despair -- personal character wobbles from constant disorientation, but the government is here to help.

The companies employing Indian call centers cannot be wholly faulted: Costs have soared. There seems to be a common impression that "offshoring" is a recent phenomenon. Yet the corporate flight has been a nonstop, one-way transfer since the gold standard entered its death throes. (Readers may decide whether this is coincidental or not.) By 1969, many wage settlements called for 30-35% increases over a three-year contract period. As dollar devaluation whipped into high gear, *Time* magazine reported: "Manufacturers decided long ago to serve foreign markets by building plants overseas, rather than by exporting. The multinational corporations will profit from devaluation." From manufacturers to call centers -- and now security analysts in India make buy-and-sell recommendations for Wall Street firms. First, blue-collar workers fell behind. Then, the middle class gasped for breath. Now, the money class is suffering. The team from Gavekal -- they of the acclaimed platform company -- noted, "It has never been so expensive to be rich." Costs for the rich have been "bid up to astronomical prices." This is their *Brave New World.*

The current debate about the rising divide between the rich and poor may be an argument whose time has passed. Maybe a forward-looking presidential candidate could upstage the competition by asking: "Are we all getting poorer together?"

"Lenin was certainly right," affirmed John Maynard Keynes. "There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."

The invisible costs of inflation may be more ruinous than prices we can read at the butcher's shop.

Regards,

Fred Sheehan