




# Inflation

Finding the right balance





**T**HE PROBLEM of inflation is as old as money itself. In ancient Rome, the debasement of silver and gold coins by Nero and his successors triggered a mild inflation that lasted a few centuries, until a misguided currency reform by the emperor Aurelian in the third century caused inflation to soar. Egypt experienced runaway inflation in 324. Inflation hit China, the first country to print paper money, in the eleventh century, when the authorities issued too many notes after spending huge amounts of *cash*—coins made of base metal—to buy off potential invaders and pay for imports.

Although how much harm is done by mild inflation is still a matter of debate, no one questions that galloping inflation—hyperinflation—which makes money virtually worthless, has been responsible for much human misery, fueling social turmoil and toppling governments.

The fear of high inflation is so strong that policymakers may hesitate to take steps to fight its obverse, deflation. According to J. K. Galbraith's assessment in *The Great Crash 1929*, so terrible were the memories of the hyperinflations and speculative booms of the early 1920s that the U.S. Federal Reserve Board continued to pursue anti-inflationary tactics in the midst of "the most violent deflation in the nation's history." Paul Krugman, in "What's Wrong with Japan?," an article originally published in *Nihon Keizai Shimbun* and reprinted in *The Accidental Theorist*, speculated that a similar phenomenon might be at work in Japan today: bad memories of the "bubble economy" of the 1980s, which some economists attribute to loose monetary policy, may explain Japan's reluctance to reflate its economy by increasing the money supply.

But the kind of general, sustained inflation—with average prices apparently rising in perpetuity—we have seen since World War II

is a recent phenomenon. Historically, when price levels went up, they always came down again. Deflation was common in the eighteenth and nineteenth centuries; the price level in the United States actually dropped 50 percent in the nineteenth century. Some economists think that there is a risk of deflation today.

Both inflation and deflation pose challenges for policymakers. Policy changes designed to fight one or the other take time to work and may backfire. If inflation has already begun to wind down by the time the monetary authorities become aware of it and put disinflationary measures in place, deflation may be the result. And if monetary authorities wait too long to tackle deflation, they may be powerless to restart the economy. Or disinflationary policies could, in an economy with sticky wages and prices, boost unemployment for a prolonged period without reducing inflation as they did in the United States and Western Europe in the 1970s.

Some economists feel that a little inflation may be the lesser of two evils, given the high unemployment and large output losses that often accompany disinflation. And inflation does not necessarily stifle growth. The development of capitalism in sixteenth and seventeenth century Europe occurred during a prolonged inflation stemming from the huge influx of gold and silver from the Spanish colonies in the Americas and population increases not matched by increases in economic output. And there are modern examples of growth with inflation. But how much inflation is too much? And does inflation always creep upward eventually?

The three articles that follow present different aspects of the inflation issue. Why do so many attempts at disinflation fail? How imminent is the risk of a global deflation? What are the chances of hyperinflation returning to developing countries? In "Back to Basics" on pages 24–25, *Finance & Development* explores inflation targeting, which several countries have adopted over the past decade as a framework for monetary policy.