

# Global Dynamic Systems Centre

## *WORKING PAPERS*

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### **The Irrational “War on Inflation”: Why Inflation Targeting is Both Socially Unacceptable and Economically Untenable**

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The inflationary genie is out of the bottle. Or so we are told by orthodox economists and their dependent politicians in Australia. The new Australian Prime Minister, Kevin Rudd, claims that “inflation is the ultimate enemy of working families”, and his Treasurer, Wayne Swan, is certain that “inflation is a ‘cancer’ eating away at living standards’. At the November 2007 election we were promised a new approach to economic and social problems, but while the rhetoric has changed the message is just the same – inflation is evil and has to be surgically removed from society. Nothing has changed. In the past, we were told by former Treasurers, Peter Costello in the Liberal Party and Paul Keating in the Labor Party, that it was essential to “slay the dragon of inflation”. Politicians, unfortunately, are captives of orthodox economists and their technical mysteries. Therefore, while we can change governments and their rhetoric, we can’t change government policies on inflation.

We are all aware of the weapon, or surgical instrument, of choice wielded by the Reserve Bank of Australia (RBA) in its role as official dragon slayer or economic surgeon – a role imposed by Federal law. It takes the form of persistent increases in interest rates. The latest interest rate increase (4<sup>th</sup> March 2008), of 0.25 percentage points, is the twelfth consecutive increase since May 2002, and the fourth in six months, taking the cash rate to 7.25 percent, currently one of the highest in the Western world. And the opportunistic private banks are exploiting these circumstances by increasing their rates to even higher levels. But this is not expected to be the end to the upward trajectory. Newspaper headlines tell us that: “RBA warns worse to come; rates to keep climbing until inflation curbed”. And the RBA’s February ‘Statement on Monetary Policy’ says, in its inimitable style, “Absent a further shift in economic risks to the downside, monetary policy is likely to need to be tighter in the period ahead”. Translated this means that the RBA is determined to pursue inflation to the brink of recession. Indeed the RBA acknowledges that unemployment is being used as a weapon against inflation. The surgical instrument, therefore, has become a meat axe, and the RBA is all out of anaesthetic.

The pain of inflation excision is palpable. While there is no evidence after six years of surgery that the “cancer” has been cured, there is growing evidence that the patient is suffering badly. “Australian working families”, as we are now referred to by politicians, are haemorrhaging. Increasingly, Australian families are finding it impossible to maintain mortgages that are absorbing up to a third of household budgets. Increasingly, family homes throughout Australia are being forced onto the market, and their former occupants are seeking rental accommodation. Increasingly, Australian families are being forced to abandon their dreams of owning their own homes. And increasingly they will be forced by the government-backed RBA into unemployment.

All this pain is necessary – or so we are told by orthodox experts – in order to stop us spending, thereby bringing inflation under control. In other words, in order to kill the “cancer” that is “eating away at our living standards”, we must be forced to reduce our living standards! At least those of us whose family surplus is already minimal and vulnerable must do so. Pain, the affluent market economists and economic consultants tell us, is good for the soul. Provided it is someone else’s soul.

There is to be even more pain. Rudd’s Finance Minister, Lindsay Tanner, is just as determined as the Treasurer and the Governor of the RBA to crush the evil of

inflation. The heavy mallet of fiscal policy is being added to the RBA's surgeon's knife in the Labor government's anti-inflationary armoury. Tanner has promised us that as a result of the forthcoming budget, in which the surplus will be increased from 1.0 to 1.5 percent, "there will be pain". While it is always important to remove excessive and politically motivated government expenditure, it is essential for the future of our society that strategic infrastructure be increased, not dramatically reduced, particularly at a time when the USA appears to be heading into recession. In any case, large surpluses are an indication of the failure, not success, of government leadership. Unless a new technologically based infrastructure is laid down immediately, Australia will cease to prosper in the future when export markets falter. By conducting an unnecessary "war on inflation", the current artificially induced pain will be extended well into the future.

This begs the question: are orthodox economists and "economically conservative" politicians correct about the evils of inflation? For the past fifteen years I've been arguing – mainly in books and articles published beyond the influence of orthodox economists – that there is absolutely no evidence for the entrenched neoclassical idea that inflation is a "cancer eating away at living standards". Quite the opposite is true. In extensive quantitative studies of the modern world (*Economics without Time* [1993] and *Dynamic Society* [1996]), I've discovered a strong positive correlation between longrun fluctuations in prices and living standards (measured by real GDP per capita). This data provided the basis for my discovery (*Longrun Dynamics* [1998]) of the "growth-inflation curve" – for the very longrun (1370–1994), longrun (1870–1994), and shortrun (since World War II) – which demonstrates that inflation is a stable, non-accelerating function of economic growth. In the period from the 1950s to the 1980s in OECD countries, high and sustained rates of economic growth (up to 5% in terms of real GDP per capita) were achieved with rates of inflation of between 5 and 7 percent per annum. And we all prospered. Hence, in viable societies economic growth and inflation fluctuate together, with prices automatically adjusting to strategic circumstances. No centralised control of prices is required.

But, the conservative armchair critic might ask, what about the well-known examples of hyper-inflation, such as Germany in the 1920s and Zimbabwe today? The answer is revealing. All societies experiencing hyper-inflation – or inflation accelerating out of control – were/are unsuccessful strategic societies. It can confidently be claimed that no viable strategic society has ever experienced hyper-inflation. In successful strategic societies, inflation is a stable and non-accelerating function of economic growth. Further, I argue that in the longrun the implication is clear and unequivocal: no inflation, no economic growth.

Yet, while there is no evidence supporting the fashionable idea of inflation as economic cancer, is it possible that orthodox economics has a persuasive dynamic theory that shows how inflation undermines the progress of civilization? I can assure you there is no such theory. Inflation targeting is a theory-free concept. Instead it appears to arise from a widespread human fear of societal change – a fear that unless someone is seen to be in charge of the levers and pulleys of the economy it will surely run out of control. In reality, no one – whether individual or institution – is in charge of the economic system, which is the outcome of a selfcreating process (see my *Selfcreating Mind* [2006]). Orthodox economists, however, are forever fantasising about their fictional world of balance and harmony called longrun equilibrium. Even

so-called neoclassical “growth theory” is not about real-world dynamics – about disequilibrium – but about convergence to equilibrium. This is a concept that economics early imported from classical thermodynamics, and has tenaciously held onto despite the shift of thought in physics to analysis of a “far-from-equilibrium” kind.

To buttress this idea of economic heaven, orthodox economists tell us that business people are a risk-averse lot, unable to make investment decisions during periods of inflation. I don't share this low opinion of the ability of the business community, which is more than capable of making investment plans during inflationary periods, provided the rate of inflation is not fluctuating wildly. Which never happens in economically successful societies. Indeed, (strategic) inflation provides both the incentive and guide for investment. Investment is curtailed only in periods of deflation, not inflation. If investment didn't occur during periods of inflation there would be no growth at all in human society.

Despite the myopic nature of orthodox economics, there is a general dynamic theory that can explain the real-world relationship between inflation and living standards that is reflected in the real-world growth-inflation curve. It is the dynamic-strategy theory that I've been developing in a large number of books and articles over the past couple of decades. While only aspects of this theory can be briefly outlined here, a full account can be found in my *Longrun Dynamics* [1998], especially chapter 11.

In the dynamic-strategy theory a vital distinction is made between *strategic* and *nonstrategic* inflation. Strategic inflation is central to the dynamic mechanism of a growing society, while nonstrategic inflation is an outcome of poor economic policy and/or external impacts like the 1970s OPEC oil crisis. In this new dynamic theory, strategic inflation is an outcome of the interaction between what I call strategic demand and the response of supply-side forces. Strategic demand comprises the effective dynamic demand exercised by decision makers for a wide range of physical, intellectual, and institutional resources required in the strategic pursuit as the society's dominant dynamic strategy (by which the desire for survival and prosperity is achieved) unfolds. Strategic inflation, therefore, is the widespread increase in prices resulting from the pressure of strategic demand on resources, commodities, and ideas.

With the introduction of a new dynamic strategy, the resulting expansion of strategic demand will lead to an increase in prices of key inputs, but will not generate strategic inflation until the new strategy exerts widespread influence throughout a given society. Prices increase because these new strategic resources are relatively scarce. Economic growth of a traditional and unchallenging kind that occurs within the context of known and available resources (such as Australian growth between 1990 and the present) may not lead to much inflation at all, provided there are no marked errors of monetary policy or heavy-handed action by monopoly suppliers. While nonstrategic inflation should be kept under control, mainly to avoid masking economic signals provided by strategic inflation, the latter should not be interfered with by would-be economic surgeons.

Inflation targeting, where this constrains strategic inflation as it usually does, acts as a brake on the unfolding dynamic strategy because it distorts the strategic incentive system. By eliminating strategic inflation in the longrun we will inevitably eliminate

economic growth. And the means by which strategic inflation is eliminated – ever higher interest rates and bigger surpluses – creates a great deal of unnecessary and unacceptable economic pain and frustration among young families, which are the future of society. It is essential to realise that this pain is not caused by strategic inflation, but rather by conservative and incorrect perceptions of the costs of inflation. Inflation is only the “enemy of working families” because the RBA has made it so, owing to its totally inappropriate policy responses. Of course, inflation does have its social costs, but these are overwhelmed by the benefits of rapid economic growth that it facilitates; and they are more easily alleviated than officially induced mortgage crises by taking measures to ensure that money incomes of disadvantaged social groups keep pace with inflation. If we wish to maximise longrun economic growth and minimise mortgage pain experienced by Australian families, it is essential to abandon the untenable policy of inflation targeting. The only “cancer” eating into living standards is the failure of economic expert and politician alike to comprehend the dynamics of modern society.

GDS  
11<sup>th</sup> March 2008

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In addition to the following references it may be helpful to view the “Overview of Publications” page on my website at <http://caligula.anu.edu.au/~snooksweb/>

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