ECONOMICS BRIEF

A short history of inflation

SINCE 1933 consumer prices have risen by 950% in America and by 4,000% in Britain. To put this another way, the dollar is today worth only 10 cents in 1933 money, and the pound is really worth a paltry 2½p. Even the supposedly cast-iron D-mark has lost two-thirds of its value since it replaced the worthless Reichsmark in 1948.

Since prices have risen almost continuously since 1933, most people today expect that prices will continue to rise every year. In fact history shows that inflation is far from "normal".

The charts show consumer prices from 1661 in Britain and from 1820 in America and Germany. Official figures do not exist that far back, but various series (of admittedly varying quality) can be linked together to give a broad picture of price movements over the centuries. Typically, the older indices covered only food and housing, and excluded services.

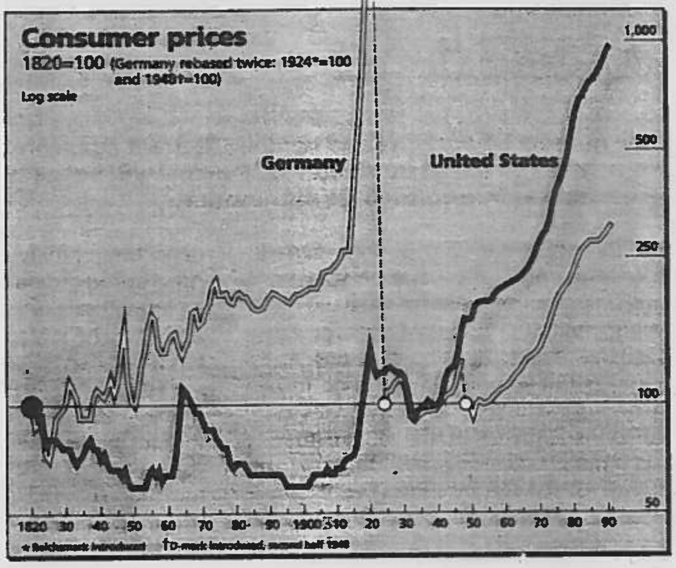
In the years before 1933, prices fell in Britain and America in more years than they rose. The longest unbroken period of rising prices in both America and Britain lasted only six years. Germany's hyperinflation in 1922-23 (when the inflation rate was over w billion %) is well known. More interesting is the fact that unlike America and Britain, where prices drifted downwards during the 19th century, in Germany prices doubled.

After falling by 40% between 1820 and 1900, American prices more than doubled during the first world war. But by the early 1930s the average price level had fallen back to its level in 1820.

The British figures, covering the longest period, are the most revealing. During the three centuries to 1933, there were only six occasions when prices increased for more than three years in a row, mostly during wars, when government borrowing soared. Prices peaked in 1813, during the Napoleonic wars, but by the end of the 19th century had more than halved again. As in America, prices surged during 1914-20 but then fell back. By 1933 prices in Britain were hardly changed from their 1660s levels.

Although it is true to say that Britain's general price level was broadly stable over the three centuries as a whole, the annual inflation rate was highly volatile from one year to another, with rates of plus or minus 10% quite common. Today, when economists talk about price stability being the only sensible goal for central banks, they mean that the price level should be stable from one year to the next, not just over a decade or so.

So far as economic growth is concerned, the volatility of inflation matters as much as its level. An inflation rate which averages 0%, but which swings from plus to minus 10%, is as damaging as one that swings between 10% and 30%—the more volatile inflation is, the more uncertainty it creates, and this discourages investment. Moreover, even if prices are broadly stable over a period as a whole, falling prices are bad for investment and growth. Nominal interest rates cannot fall below zero, so falling prices result in painfully high real interest rates.



Price stability, however, is not necessarily the same as zero inflation as measured by consumer-price indices. These indices, which measure the weighted average of price changes for a fixed basket of goods and services, tend to overstate the true rate of inflation for two reasons.

- First, they do not adjust fully for improvements over time in the quality of goods and services. Some of the rise in a price index may reflect better-quality hi-fi equipment, say, rather than general cost pressures.
- Second, in many countries the weights used to combine the different goods are often out of date. Britain updates its weights every year, but in America they are revised only every ten years (the current index is based on 1982-84); Germany's index is based on 1985. This exaggerates price rises over time, as it does not allow for changes in consumption patterns in response to changes in prices—consumers shift away from goods that are becoming comparatively more expensive towards cheaper alternatives.

So would you recognise price stability today if you saw it? Central banks, such as the Reserve Bank of New Zealand, define price stability as 0-2% inflation. A zero inflation rate reported by officialdom may in fact imply falling prices.