THE HISTORY OF INFLATIONARY REVOLUTIONS

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Abstract

This paper represents a historical analysis of the major pivotal points in the history of monetary economic regulation. On the basis of this analysis the author identifies that inflationary revolutions in the economic thought precisely fit into T. Kuhn’s “Theory of scientific revolutions”. This research mainly aims to highlight the attitude of ideological revolutionists to a question of whether or not inflation causes economic growth and to what extent monetary expansion can be justified. The author employs T. Kuhn’s theory of scientific revolutions to explain why some innovative monetary theories, which anticipated economic crises, actually had not prevented them.

Keywords: Crisis, Inflation, Keynesianism, Mercantilism, Classical economics, Monetary policy, Scientific revolutions.

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Introduction

Throughout the history of economics the attitude of mainstream economists to inflation and inflationary methods of monetary regulation has changed many times. In the XVI-XVII centuries mercantilists inspired by late scholastics, Calvinism and large imports of American gold to Europe advocated that the increase in supply of money can cause economic growth. Then the mainstream economic thought made a U-turn when the classical political economy emerged in the mid of XVIII century and the quantity of money was no longer considered as a determinant of economic success. Finally, the Keynesian revolution brought a rich crop of monetary thinkers who rediscovered and advanced the monetary methods of economic stimulation.

These shifts in the basic assumptions of the mainstream economic thought were mentioned by many scientists who addressed the history of economics in their works. Blaug, Rothbard, Schumpeter and other prominent economic historians wrote about the revolutionary pivotal points in the understanding of monetary policy. However, there were made only slight attempts to explain the nature of these revolutions.

The objective of this paper is twofold. First, to analyze and compare prerequisites, flow and outcomes of revolutions in understanding of monetary policy. Secondly, to develop a universal pattern of inflationary revolution.

Research methodology is derived from its objective. The author employs a comparative-historical research methodology. The historical analysis focuses the time span from XVII to the beginning of XXI century. The paper is heavily influenced by the T. Kuhn’s philosophy and uses Kuhn’s criteria for the analysis of paradigm shifts in the course of development of monetary economic policy.

This paper highlights an attitude of ideological revolutionists to a question of whether or not inflation causes economic growth and to what extent monetary expansion can be justified.

The Overthrow of Inflationary Mercantilism: Emergence of the Classical Political Economy.

The idea that the more amount of money can benefit national economy reached its apogee in the mid-end of the XVII century. This idea had deeply ingrained in economists’ minds as a basic assumption for macroeconomic management. Generally, this approach was put in practice by debasement of coin and decrees lowering the maximum usury rate. The former helped to replenish European treasuries while the latter was expected to bring about various social and economic improvements.

Francis Bacon believed that lowering the usury rate to five percent will raise the price of land and encourage profitable entrepreneurship (Bacon [1625] 2008 p.93). Thomas Culpeper, the British mercantilist wrote a very influential Tract Against the High Rate of Usury (1621). Culpeper declared that Dutch prosperity was caused by their low rate of interest; that the English high interest rate crippled trade; and therefore the government should force maximum interest rates down to outcompete the Dutch. Another prominent mercantilist, Josiah Child treated lowering the maximum rate of interest to 4 per cent as virtually a panacea for all economic ills. A lower rate of interest would vivify trade, and raise the price of land; it would
even cure drunkenness (Rothbard [1995] 2006 p.318). English parliament was forced to lower the maximum usury rate from 10 to 8 and then to 6 percent. French, Dutch and Spanish mercantilists advocated similar inflationary measures.

By the end of the XVII century, mercantilism faced crisis. Clipped and debased currency lost its value, while low level of interest rates caused outflow of capital which could not be stopped by the laws forbidding export of gold. Eventually, inflationists attempted to continue growth by creating national banks and investment bubbles. The Bank of England was established in 1694 to inflate money supply and finance government’s debt. Later, the South Sea Company began to operate in order to absorb the inflow of inflated money. Similar schemes were adopted in many countries simultaneously but probably, the John Law’s scheme turned out to be one of the most famous inflationary fiascos.

John Law attained an influence on the financial system of France in 1716 when after the death of Luis XIV the regent of France Philippe d’Orleans had approved the Law’s scheme. His main argument was that the quantity of money determines the economic activity of a nation. The Addition to the Money, will employ the People are now Idle, and these now employed to more Advantage: So the Product will be increased, and Manufacture advanced. (Law [1705] 1750 p. 198)

The significant economic downturn preceded the Law’s reforms. The national debt amounted to 3,5 billion livre, and a deficit of 150-200 million livre accumulated every year (Wiston-Glynn [1907] 2008 p. 34). Social unrest and widespread corruption accompanied the budgetary deficit.

John Law on the one hand had founded an issuing bank which bought out the national debt for paper money, and on the other hand - a publicly traded company Compagnie des Indes which absorbed the money supply in a form of investments in the shareholding capital. French economy got a tremendous growth impulse. One paper money emission followed the other while capitalization of the stock market grew.

The grandeur of Law’s system could be compared only to the scale of its collapse. When the stock trading had become less intensive, not only a stock price had fallen, but all the paper money had become superfluous in the national economy which resulted in a skyrocketing inflation.

The most negative consequence of the Law’s scheme was a steady aversion to any economic reforms in the reign of Luis XV. John Law escaped France and his name remained an object of condemnation for many years.

The absolute necessity for changing the basic assumptions in economics appeared when both Compagnie des Indes and South Sea bubble finally burst in 1720. This necessity caused emergence of the new economic theory. However, the laissez-faire doctrine and the assumption of saving-investment parity originated before the collapse of the XVII century inflationism. Dudley and Rodger North are commonly seen as precursors of classical economists, ostracized from the governing process by mercantilists. In 1691 they have published Discourses Upon Trade: Principally Directed to the Cases of the Interest, Coinage, Clipping and Increase of Money (North [1691] 2004) criticizing artificial lowering of usury rates and inflationary schemes of mercantilism.

When the influence of mercantilists exhausted, the mainstream economics suffered a major retooling. Classicists replaced mercantilists in the high offices of different states. Classical economics had set aside the practice of monetary manipulations for more than two centuries, and all the benefits of the inflationary policy were neglected until the classical approach was finally discharged by the Keynesian Revolution.

**Scientific Prerequisites for the Keynesian Revolution**

It will not be an exaggeration to say that the XX century was an age of monetary manipulations. The major role was played by the fact that after the Great Depression in the 1930th the classical economics was almost destroyed and displaced by more or less radical approaches of Keynes’s adherents. Then followed the post-war boom and further issuing of paper money, which finally resulted in the complete abolishment of the gold standard in 1971-1974. The most progressive economists adored to the genius of Lord Keynes who had invented and developed the theory which must have prevented deflationary economic slowdowns in the forthcoming «mature economy» with a diminishing return on investments.

A comparison of the events of 1720th and 1930th might show that the structure of Keynesian revolution is much akin to the structure of the classical revolution in the XVIII century. Just as in the case of classical revolution, Keynesian revolution had its scientific precursors too. The major theoretical fundamentals were established by Rudolf Hilferding (Hilferding 1910), Joseph Schumpeter (Schumpeter [1911] 1934 ), L. Albert Hahn (Hahn [1920] 1930), and it is not a mistake to say that many other economists of the late XIX – early XX century shared the similar point of view. They believed that credit leads to the
transfer of purchasing power to entrepreneur and to increase in his turnover, in spite of that he hadn’t actually earned it. Those businesses which raise more funds become more competitive in market. So the credit becomes a determining variable of the national output. Banks provide economy with enough purchasing power to accelerate the economic growth. The additional funds for granting of credits can be created through debasement of coins or issuance of the fiat money. The following inflation will be simply a relocation of the hoarded funds.

Although these theories were revolutionary and opposite to the widespread adopted classical economic doctrine, they did not represent the general standpoint on the issue. Hahn was the first who summarized their assumptions and presented the complete theory of employment, credit and inflation. Later Schumpeter praised Hahn in the English edition of Theorie der wirtschaftlichen Entwicklung 1934. Schumpeter wrote that the line of thought that is expounded fundamentally unchanged in the following has in the meantime received valuable substantiation and improvement from the investigations of A. Hahn in his Volkswirtschaftliche Theorie des Bankkredits. (Schumpeter 1934 p.95)

In 1949 L. Albert Hahn had published the book in which he claimed that many of Keynes’s statements were very similar to those which he had written in his Volkswirtschaftliche Theorie des Bankkredits as long ago as 1920, 9 years before the Great Depression, and 16 years before publishing of the first edition of Keynes’s General Theory of Employment, Interest and Money.

In Hahn’s opinion, the following statements coincided:
1. Employment and production are dependent upon demand, but demand is not automatically created by production or employment.
2. An increase in income leads to an absolute increase not only in saving but also in the proportion of income saved, i.e., in the saving-income ratio.
3. The consumption deficit can be harmful because the purchasing power withdrawn by savings does not necessarily come into the hands of entrepreneurs seeking funds to invest.
4. Certain preclassicists, especially Malthus, deserve praise because they saw much better than Ricardo and other classicists that savings interrupt the flow of demand.
5. Savings are not automatically absorbed by investments because money is essential also as a means of liquidity.
6. Liquidity requirements are a highly subjective matter, depending upon confidence and speculation.
7. Interest rates are in large degree determined conventionally.
8. The liquidity of even long-term investments can be improved by creating “indirect liquidity”
9. If lack of investment – caused by interest rates too high to guarantee that investment will absorb savings – makes for a deficiency of effective demand, and thereby unemployment, a reduction in interest rates must bring about employment.
10. The reason a reduction in interest rates must bring about employment is that it alters the distribution of income in favor of entrepreneurs, …
11. The limit to increasing employment by reducing interest rates is reached when the labor supply cannot be augmented by further wage increases.
12. The net effect of an increase in effective demand following an expansion of credit is generally twofold: on prices, on the one hand; on production on the other.
13. Technological progress tends to reduce prices directly or through the pressure it exerts on wages through labor-saving machinery.
14. Employment can be increased either by lowering wages or by expanding credit. In the general case the latter is to be preferred.
15. As booms end when demand becomes deficient, new demand must be created. This can be done by making new investments profitable by lowering interest rates, i.e., through an easy-money policy.
16. If, despite lower interest rates, demand is not created, the government must and can replace private demand by public spending. (Hahn [1949] 1987 pp. 213-226)

This list shows that the essential background for the Keynesian Revolution appeared before the Great Depression. So why the Great Depression had not been prevented, and why it is the Keynesian inflationary theory that had become the basis for the new general economic theory?

Michael Hauck argues that Hahn was an economic outsider, he had no stable economic conditions and access to state authorities, as Keynes enjoyed, and he had to conduct banking business along with research activities (Hauck 2009 p. 139). But Hahn was not the only inflationist of the beginning of the XX century.
Moreover, he had many followers even after he had changed his mind and criticized inflationary regulations as a means of artificial support of an everlasting economic boom.

The answer roots in the sequence of historic events. Obviously there was no use of Hahn’s discoveries until the crisis of the classical economic theory had happened. The history of economics gives a lot of examples that a government was highly reluctant to accept any innovations if it had been relying on an existing theory for some prolonged period of time. Economists in high offices are very like to generals who prepare for the last war. Generally speaking, the fact that scientists avoid changing their basic assumptions until they turn out to be fallacious is true regarding most of the sciences. It is remarkable how precisely the Keynesian Revolution fits into the conceptual framework of the American philosopher of science Thomas Kuhn. Kuhn believed that as in manufacture so in science - retooling is an extravagance to be reserved for the occasion that demands it. The significance of crises is the indication they provide that an occasion for retooling has arrived. (Kuhn [1962] 1970 p. 76)

The Great Depression was not the first underinvestment crisis. However, the previous economic shortfalls were either local or they were obviously caused by factors which were exogenous to the economic activity (such factors as wars, embargoes and manipulations with monetary standard). So, the Great depression became the event which triggered the Kuhn’s mechanism of scientific “retooling”. The similar is true about the simultaneous French and British economic shortfall in 1720.

Kuhn’s theory of scientific discoveries clarifies why we are speaking of the Keynesian Revolution as the genesis of modern inflationary anti-crisis regulations. Although much of the Keynesian discovery had been anticipated by Hahn and other economists, his works could not overture the dominant classical economics because it had been standing firmly on the shoulders of Adam Smith and David Ricardo for some 150 years.

The inflationary theory of wealth creation was very much in contrary to the prevailing point of view and in many cases similar to mercantilists’ ideas. Inflationists endeavored to undermine the basic assumption of the classicists that saving and investment must always be equal. The new theory had proposed that during the cyclical economic contraction hoarding can result in underinvestment and deepen the crisis, and the state should accelerate the demand and thereby the investment. Such a claim could not find a place in the economy of the 1920-1930th without drastic changes in it. The state authorities had been conservative until the Great Depression broke out. It had set a glaring precedent of the unequal saving and investment and thus shook the convictions of the mainstream economists. Only at that time the necessary background for a deficit spending and inflationary monetary manipulations had formed.

Since “retooling” happens only when empirical data opposes general knowledge, a pure discovery process can start only when scientists are able to recognize and measure the depth of a problem. This statement can also find corroboration in the Kuhn’s book: Discovery commences with the awareness of anomaly, i.e., with the recognition that nature has somehow violated the paradigm-induced expectations that govern normal science. … Assimilating a new sort of fact demands a more than additive adjustment of theory, and until that adjustment is completed – until the scientist has learned to see nature in a different way. (Kuhn [1962] 1970 pp. 52-53) Kuhn admits that the solution to each of [crises] can be at least partially anticipated during a period when there was no crisis in the corresponding science and in the absence of crisis those anticipations had been ignored. (Kuhn [1962] 1970 p. 75)

There could have been no Keynesian Revolution without the Great Depression, nor could classical economic theory overrule mercantilism without failure of inflationary schemes in 1720, although in both cases there had already been the major scientific prerequisites.

When a major economic crisis strikes it triggers scientific revolution. That time a new theory emerges to correct the old one. Not only the new theory corrects the basic fallacy of the former, but it replaces it and brings new fallacious assumptions. Usually, public sees an economic boom as an achievement of the progressive economic theory and takes all its assumptions for granted and vice versa, an economic slowdown causes a general mistrust of everything related to the traditional one. The science could not join the classical and the Keynesian assumptions and switched from one general theory to the other which naturally neglected achievements of the classicists. Later, monetarists in the course of the “normal science” found some of Keynesian misjudgments, and this inflationary regime has been coping with economic slowdowns by today. Current mainstream economic thought has inherited at least two inflationary assumptions from mercantilism.
First one is that perpetual increase of the national supply of money stimulates production and trade. Second one is that artificially low level of interest rates provides more investment opportunities.

The history of monetary revolutions shows that when weakness of the prevailing theory led to the crisis, revolutionary changes in economics happened. This sequence of booms and falls can be called the cycle of economic thought (Figure 1.).

![Figure 1. The Cycle of Economic Thought](image)

One theory fixes negative results of the other. Strict following to the canons of the inflationary theory sooner or later leads to a crisis and the more monetary-prudent open-market economic movements take the control in their hands restoring and renewing the deadlocked economy. But they can’t last economic growth perpetually, and the policy of inflationary interventions again gets the upper hand. Until the time when these oscillations of scientific thought do not slow down, the crises of significant magnitude will periodically occur in the economies of developed countries ruining much of achieved economic knowledge and wealth. Each time there will be a place for the “new” economists and politicians who will have to introduce revolutionary ideas to the public opinion and overcome the crisis.

**Conclusions**

Scientific revolutions in the monetary economic thought follow the Kuhn’s pattern of the scientific paradigm shift. Moreover, T. Kuhn’s philosophy appears to explain why some economists remain neglected, while other economists become vastly famous even if both, the former and the latter advocated similar monetary measures.

When a significant international crisis happens, the old theory (i.e. a theory which is based on the mainstream basic assumptions) strives to overcome the economic slowdown. Should the mainstream theory fail, new monetary assumptions arise to bail out a struggling economy. The theory based on new assumptions must not necessarily present an entirely new monetary approach. This approach is more likely to be taken from the periphery of economic thought.

The comparative analysis of the fall of mercantilism and the fall of classical political economy showed that monetary revolutions have their scientific precursors, triggering crises and shifts in basic assumptions of the mainstream economic thought. The historical analysis shows that the age of macroeconomic monetary manipulations followed the age of individualism and liberalism, and then the new round of revolutionary changes began.

The science of economics is vulnerable to the reoccurrence of the same crises and revolutions because neither hard-money nor inflationary approach taken separately can lead economy to prosperity. Relying on this fact the article suggests that there might be a cycle of inflationary economic thought, when a period of inflationary monetary regulations is followed by a period of hard-money economic approach.
References