

## Mephistopheles and Inflation\*

By Karl Brunner, Rochester

„Wir wollen alle Tage sparen,  
und brauchen alle Tage mehr“  
„Ein solch Papier, an Gold und Perlen statt,  
ist so bequem, man weiss doch was man hat.“

„So stempelten wir gleich die ganze Nacht  
Zehn, Dreißig, Fünfzig, Hundert sind parat,  
Ihr denkt euch nicht, wie wohl's dem Volke tat.“

Wolfgang Goethe, Faust II

Human history entered a new phase over the past fifteen years. We moved into an era of permanent and worldwide inflation. This worldwide nature of persistent inflation confronts us with a remarkable and historically unique event. Inflation itself is, of course, not a new experience. The Roman Empire occasionally suffered from it and so did various regions of medieval Europe. Many countries experienced inflationary episodes over the past 500 years. The most dramatic cases, of course, are the hyperinflation observed by a small group of nations in Europe after the last two world wars. The United States of America shared this common experience. It appeared four times over its short history. This pattern contrasts however with our most recent historical environment. Permanent inflation remained confined to limited regions of the world. Other occurrences were usually associated with wars and their aftermath. They emerged as temporary financial emergencies lasting at most for some years. Hyperinflations in particular could not persist. The nature of their internal process leads to their own destruction.

A rough survey demonstrates the radical change in our fate. Switzerland was the only country which managed for a few years during the last decade to avoid the general fate. There remain of course massive differences between the many nations. Some countries, exemplified by West Germany and

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Switzerland, manage to hold inflation in the average substantially below 10% p.a. Other countries, like the United Kingdom and Italy, produce inflation rates averaging 20% p.a., while other nations, such as Brazil and Israel, reach beyond 100% p.a., and Chile under the Allende regime about 1000% p.a.

The differences between nations at any given time are matched by remarkable differences over time within the various countries. Swiss inflation moved during the past decade between 0 and 12% p.a. The Brazilian experience shifted between more than 100% and 15% p.a., and of course Chile produced extremes of 1000% and 10 - 15% p.a. Lastly, the worldwide experience does not respect the tight controls of totalitarian regimes.

The radical change in the pattern of inflation observed in our most recent history poses a serious political threat to our society. It also confronts us with an intellectual problem. We need to understand the forces at work before we can rationally expect to influence their operation. And perhaps, once we understand the process underlying the new phenomenon, we may wonder whether a change in policy required to control the drift is acceptable in our environment. Still, blindness, incomprehension and misunderstanding offer no intellectually satisfactory position. They produce moreover on the political arena – as we shall see – continued opportunities for the operation of the underlying inflationary conditions.

What are the conditions responsible for our age of permanent inflation? Can we hope for an adequate explanation? Indeed we can. The scholarly work of many economists contributed over many years to the gradual evolution of a coherent story. Some strands of this story remain quite tentative at this time, whereas others are well established and strongly confirmed by the work of many independent scholars. But let us approach our answer somewhat indirectly with a detour over classically romantic German literature.

*Wolfgang Goethe*, the Grand Seigneur of German literature, died 150 years ago, after spending a good part of his old age finishing the second part of *Faust*. This drama is in many ways a strange story and encouraged many different interpretations. It offered marvelous opportunities for an homme de lettres to explore the complex fabric of Goethe's metaphysical and mythological imaginations. I have no wish to discuss this activity nor have I any desire to add to it. Within the intricate patterns of the drama occurs however the outline of a basic theme with remarkable relevance to our time. This theme contains a clue to several important strands of our answer. You are invited to follow my modest detour and join me for an unsentimental look at this man *Faust*, his failures, aspirations and his environment.

The drama opens on a total human failure. Faust ponders his condition after years of learning and teaching. His heart is joyless, his soul empty and his mind blank. Life confronts him as a barren wasteland. He invokes the tellurian forces of darkness for help in his escape from existential hell. Thus enters *Mephistopheles*, offering Faust a deal: the use of magic in exchange for his soul. With the exercise of Mephisto's magic he follows now his aspirations filling the void of an empty life. These aspirations consist of sexual pleasures and power, the latter increasingly important as the story evolves. We need not linger on the *Gretchen* episode for our purposes, the witches' Walpurgis night, and assorted mythological adnumerations required apparently for a German intelligentsia market. Two episodes offer however suggestive material for our central purpose. This is Faust at "the Emperor's" court and Faust the "visionary builder" in the second part of the drama.

*Faust* and his companion *Mephisto* appear at the Emperor's court in the middle of a "budget debate". Army commander, chancellor, court marshal and treasurer, all complain to the Emperor about insufficient funding of their manifold activities. Mephisto offers a simple solution and suggests that the Emperor create his own paper money, "backed up" of course by all the unknown and buried treasure of the earth within the empire (or somewhere). So army commander, court marshal, chancellor and treasurer happily spend the night creating money of increasing denominations. They assuage the Emperor's doubts and seem to convince themselves that the diligent financing of their multiple pursuits with newly created money is truly in the interest of the people's welfare. "Des Volkes Heil" and "Des Volkes Wohl" are incantations flowing easily from the officials' lips. Mephisto's deceitful argument to overcome the initial doubts of the officials is also noteworthy for our subsequent exploration of the political economy of inflation.

The episode of *Faust* as a "visionary builder" toward the end of the drama is in crucial ways more sinister. It also alludes to subtle but pervasive strands shaping political processes in our century. Faust was given some piece of land along the sea for his services rendered to the Emperor. This land becomes his base for an ambitious project to build a huge dam. Faust envisions a vast new land wrested from the sea to offer life and freedom for a vast populace. His dream of a paradisaic state is pursued however with the ruthlessness of a murderous tyrant. There is no compassion and no concern for those who stand in the way. The "impossible dream" mobilizes the darkest forces and imposes untold human sacrifices. What Faust considers – under *Mephisto's* guidance as a masterpiece of human achievement – finally becomes a terrible exercise in inhumanity.

What possible illumination can we derive from *Faust's* story? It contains several strands which offer clues to the new and worldwide inflation problem. The scene at the imperial court addresses immediately the proximate cause of inflation. Other strands of this scene combined with the pervasive theme of a wasted intellectual grasping at power for meaning in life suggestively point to crucial socio-political conditions shaping our drift into permanent inflation.

The immediate and much easier part is the proximate cause of inflation. There is little mystery about this and the explanation need not be complicated. Many influences indeed can shape the movement of the general level. It typically moves quite erratically from one month to the other, or from one quarter to the other. There is no useful purpose however in attempting to understand these passing erratic motions. They do not confront us with any serious problem. Any attempt on the other hand to tamper with them would create problems for the economy. Large and persistent changes in the price-level over many quarters or years are an entirely different matter. They are produced by a systematic driving force. We understand this force and can potentially cope with it. This driving force is a nation's money stock.

In every country at any time there is some quantity of money in existence. This quantity consists of all assets held by the public used with dominant frequency and regularity for making payments. A persistent rise in their quantity induces a corresponding rise in the price-level. Larger masses of money mean that more money will be supplied in exchange for goods and services. As the latter magnitude expands less, less goods are available per unit of money. The markets express this fact by a rise of prices expressed in money. This rise reveals to us that too much money has been created in relation to the goods and services produced in the economy.

We may look all over the world and we will find the same basic pattern. There exists for every nation a critical benchmark level of monetary growth (i.e. growth in the nations' money stock) determined by its maintained growth of production and some other factors. Wherever we observe the inflationary patterns summarized at the beginning of my lecture, we will also observe an excessive growth of the nations' money stock. And whenever you observe an excessive expansion of the money stock, maintained over a substantial period, then you will also find the persistent inflation characterizing our worldwide scene.

Much more can be observed however. You will note that the broad difference between the nations' inflation rates at any time correspond approximately to the differences in the rate of monetary expansion. Similarly, the

large differences in the observed inflation rate within a nation over time follow the pattern of evolving monetary growth. You will never observe an acceleration of monetary expansion from 0 to 10% p.a. or from 10 to 30% p.a., or from 30 to 100% p.a. without a corresponding rise in the rate of inflation. Our past and recent history demonstrates that it is by far easier and less costly in resources to create money than to create goods. The large variability of the money stock or its growth rate and the ease with which it is pushed beyond the critical benchmark demonstrates this difference.

But where is all that money coming from? Once upon a time most money consisted of metallic coins of one kind or another, minted and issued by kings, princes and cities. The metallic content of money seemed to prohibit arbitrary variations in the total amount. The manipulators of political power understood however quite well that issues of money could be used to extract resources from the general public for their political purposes. The new money created could be applied to finance the court, an army or other enterprises a prince wished to consider. This way of financing avoided moreover the political trouble associated with the usual and explicit taxes. *King Jean Valois* II of France understood the advantage of money creation over standard methods of taxation quite well. So he tinkered with his currency over 70 times during his reign. He created the money for his purposes by lowering the metallic content in the coins. More and more coins could thus be produced out of the available metal.

*Mephisto's* proposal was certainly more efficient than the French King's technique. It enlarged the princes' power to exploit the monetary institution for their political purposes. Once the financial markets spontaneously developed paper money as a convenient representative and claim against more cumbersome metal, the political powers recognized an improved opportunity to use money creation as a means to finance their expenditures. Banks emerged with special charters granting the monopoly of issuing bank notes. The privilege of this monopoly charter was usually granted for favors received, and the favor received money created by the bank under the monopoly for the government. These chartered banks with a monopoly of note issues evolved over the past 2000 years into modern Central Banks.

Our modern Central Banks form the basis of our monetary system. They possess under prevailing regulation a monopoly for issuing "base money", i.e. currency and reserves held by the banks against their liabilities. Many of these liabilities, consisting of so-called transaction accounts, are also money. Transfers between these transaction accounts are in modern economics the major form of executing payments. Modern bank money, consisting of these transaction accounts (e.g. checking deposits) together with

the currency issued by the Central Banks, constitutes today a nation's money stock. This magnitude, in spite of its dominant composition by bank money, is closely controlled over time by the "monetary base", i. e. the total amount of money directly issued by the Central Bank. We find that over all periods and all nations large and persistent changes in the nation's money stock are produced by corresponding changes in the monetary base. And, this is the crucial point: this monetary base is immediately and fully determined by the Central Banks' behavior.

I belabored all these somewhat technical points in order to emphasize the technological progress made since *Mephisto* and the court officials spent the night to stamp out paper money. I most particularly want to convey to you that the monetary expansion, necessary and sufficient, to unleash and maintain inflation in modern societies can be traced to the behavior of our Central Banks. Their behavior determines, not within days, weeks or a few months, but certainly over quarters and years, the magnitude of our monetary expansion. If you find Central Banks raising their volume of base money at 10 to 20% p. a. or more, you will not find the nation's money stock limping along at a growth of a few percentage points. It follows that excessive monetary expansion, the proximate cause of inflation, cannot emerge without the Central Banks' specific behavior. Their behavior corresponds to the actions of *Faust's* imperial court so enthusiastically printing out the money the court officials require to attend to "the people's welfare". So this is where, ultimately, all the money comes from.

But why do Central Banks behave that way? Well, at this point we approach the harder part of our problem, but the officials at the imperial court and *Faust's* search for meaning in the context of political power may yet yield a clue. Our answer is buried in the nature of the political process and the peculiar ambivalence of political structures and institutions. The basic theme was already revealed by the imperial court's chancellor when he lamented that officials try to save every day, they need ever larger revenues to finance their projects. We also observe this basic theme in the exploitation of the monetary institution by potentates, kings, and princes. Their perennial search for revenues led them again and again to use their power over money to create money as a means to finance their budgets. But the time of kings and princes is passed and we live under very different political processes. Indeed, but it appears in some respects not that different.

Political structure protects the members of a given society against the "zero sum game" of anarchy. *Hobbes'* description of this state of nature is well known. Men find it to their own advantage under the circumstances to overcome this state. Anarchy hardly ever persists in man's affairs. Their

spontaneous interaction, guided by their diverse and personal interests, will evolve some political structure. Such order creates incentives to produce, invest and trade, i.e. activities obstructed by the endemic threat of loss by robbery and piracy through violence under anarchy. The tremendous social productivity of political structure should be quite obvious.

There is another dimension to the story however. Man's disposition to improve himself and acquire wealth proceeds under any environment. Political structure channels and regulates this disposition in specific ways. But the institutions constituting the political order are not neutral. While they impose rules of the socio-political game they also offer new opportunities to the participants in the game. All political institutions offer especially opportunities of wealth redistribution.

Participants of the socio-political game can acquire income or wealth by investing resources in socially productive activities, in production and trade. Their private endeavors at wealth acquisition contribute in this context to raise social wealth, the general level of welfare. But they can also direct their efforts to use political institutions and the political process in order to extract income and wealth from others in the society. This private effort yields however no social benefits. It actually distracts valuable resources from socially productive use. But depending on the nature of the political structure the private gain obtainable from "political investments" can be very large indeed, even if its social productivity is negative. The ambivalence of political structure is thus determined by its social productivity relative to anarchy, combined with the inherent opportunities offered for wealth redistribution under the more or less implicit rules of the game constituted by the political order. We recognize thus in redistribution the central nature and driving force of the political process. But we need also to recognize that the stability of a political order depends on its incentives and opportunities fostering redistributive efforts and investments. Some basic measure of redistribution is most probably a necessary condition for a stable order. *James Buchanan* has elaborated this aspect and *Robert Nozick* recognized this element in the constitution of a minimal state. But an expanding wave of increasingly persistent redistributive activities gradually induces a crisis of the political order. This crisis will be reflected by a more or less tacit but increasing disavowal of the rules of the game. There evolves a spontaneous search for new rules expressed in many countries by the evolution of an "underground economy".

Our political theme requires at this stage some further elaboration in order to find a major link between the political process and the monetary expansion directly responsible for permanent inflation. A democracy is

characterized by an explicitly regulated competitive game for power. The required regulation is determined by a constitution, the corresponding legislation or simply a well understood tradition. We also encounter a political apparatus expressed by the bureaus of the government. Politicians and bureaus may be usefully viewed as entrepreneurs operating on a political market. These entrepreneurs pursue their interests addressed to achievable positions and the associated influence over the use of resources. They compete for influence and positions with programs and ideas offered on the political market. All these programs or ideas bear, in one way or another, on the government's budget or involve regulatory activities modifying the distribution of wealth between various social groups. Both politicians and bureaus compete thus for support by voter groups with programs and promises involving benefits for these groups. Some specific properties of the political market determine ultimately the peculiar bias built into the structure of the political process, a bias already noted by *Faust's* imperial court. This bias follows from the pervasive information problem confronting the members of the political order.

Information about a program benefitting a particular group is more easily accessible and at much lesser cost to the beneficiaries under the program than to most of the rest. This asymmetry in information costs is reinforced by an asymmetry in benefits and costs associated with the program. The benefits usually accruing to a well defined group are comparatively large per person, whereas the costs to be born by all taxpayers are small per person. This pervasive fact implies that the benefits from investments made in the political market in order to obtain a specific program are large, whereas benefits on investments made by taxpayers to oppose a program are quite small and most of the time remain well below the respective cost of investments.

This asymmetry of information and in the distribution of benefits and costs under specific programs crucially affects the nature of the political process. It implies in particular that the political process typically produces programs addressed to specific and well defined groups. We rarely find programs involving a redistributive scheme uniformly across income groups. We also typically find that old programs hardly ever disappear. The competitive survival of politicians and bureaus thrives on "new programs" or specific extensions of old ones. Proposals to abolish or contain old programs promise no winning strategy for a politician and offer no attraction to a bureau. Promises to offset the burden of old programs imposed on particular groups by new programs with benefits specially tailored for these groups are a much more effective strategy.



This sketch of crucial aspects of the political process in modern democracies extends with some modifications to various oligarchic structures including military regimes. These political arrangements are not immune to the basic forces described. They are moreover not a monolithic organization. They are usually subject to pervasive internal conflicts for power and influence. The process driven by these conflicts also involves a competitive use of programs containing a variety of redistributive strands. No oligarchy, military or otherwise, can persist without auxiliary groups beyond the immediate power centers. The more or less active support of these groups is “bought” by appropriate programs. The history of military regimes and oligarchies exemplifies this process.

One more step leads us to our goal. The competitive drive on the political market with the built-in bias for ever new programs and extended programs unavoidably expands the budget. This process, revealed by the remarkable increase of the budget relative to national income, dominated all western democracies. But the same properties of the political process favoring the expansion of expenditure programs retarded a corresponding increase in tax revenues. Increasing tax rates induce moreover a widening search for effective avoidance of tax payments. The evolution surveyed produces under the circumstances a persistent deficit in the government’s budget. The basic nature of the process will also create a pervasive impression of “uncontrollable forces” producing an “uncontrollable budget with an intractable deficit.”

Deficits need be financed. If the political process refuses to adjust taxes, i.e. politicians quaver and citizens’ groups benefitting from expenditure programs march on the legislature, the government may borrow or accept *Mephisto’s* advice. As it happens, financing a deficit, at least to some extent, with new money created by the Central Bank, offers great advantages to governments and politicians. They obtain revenues to finance their expenditure programs without the political difficulties associated with the legislation of explicit taxes. It also avoids the political problem emerging in response to massive and persistent borrowing on domestic or foreign capital markets. Lastly, countries with capital markets underdeveloped or emasculated as a result of past policies find the recourse to the Central Bank easier and politically most feasible. The evolution of events in Italy and the United Kingdom over the past 15 years illustrate our general description with remarkable clarity. So does the history of many Latin-American countries. And, as we know, the United States has hardly been immune to *Mephisto’s* problem. One minor qualification: the monetary expansion induced by the political process may on occasion be associated with policies independent of

the budget. They may result from implicitly redistributive arrangements involving more or less direct credits from Central Banks to portions of the private sector. The pursuit of some exchange rate policies offers one example.

Some remarkable passages in *Faust's* drama alert us to an important aspect of the political process. We noted above how the veil screening the crucial facts against a full perception by the citizens contributes to the evolution of an "overgoverned society with a built-in inflationary bias." This incomplete information shaping the nature of the political process is pervasively reinforced by the pattern of systematic disinformation created by the competition between politicians and bureaus for position and influence. *Mephisto* lies and misleads the Emperor. He sneers at the initial hesitation of the court officials to misdirect their attention, in a passage incidentally which was frequently quoted by the intelligentsia with great approval. Note also Mephisto's impressive flow of words to produce some *Orwellian* inversions of impressions and meanings. Lastly, once the court officials have understood their advantages accruing under Mephisto's proposal they smoothly convince the Emperor that everything proceeds for the people's welfare and benefit.

The disinformative use of language forms an essential by-product of the political process. *Frank Knight*, one of the great economists of this century, once remarked at a Presidential address of the American Economic Association, that "truth has no political function". His statement refers to the phenomenon observed at the Emperor's court. Political programs and ideas seem more easily sellable on the political market if their benefits are exaggerated, particularly to those who do barely benefit, and their costs underestimated. According to some account most Congressmen in the USA hardly appreciate the consequences of most legislation they vote on. Nor do they know even in roughest outline the cost their actions impose on citizens. But then, there is really very little incentive to obtain this information. Such effort requires some costly investment (at least some valuable time) and adds little to their survival in the political market.

Most important for our problem is the disinformation spread over the political market in matters bearing on inflation. A coalition of politicians, bureaus and Central Banks can be expected to supply the citizens with pronouncements attributing inflation to a shifting variety of conditions. This disinformation makes it more difficult for citizens to perceive the nature of the issues and in particular to perceive the nature of the inflation problem. The resulting misconception or confusion protects politicians and Central Banks from any effective public accountability for their responsibility.

Politicians and members of bureaus who know better and fully understand the issues will find it difficult and occasionally quite painful to articulate their views. Truth, as *Knight* reminded us, has an uncertain political appeal and an ambiguous function in the political market. Words become under the circumstances increasingly an instrument of manipulated impressions.

The role of the media and the intelligentsia need also be considered in this context. The media share with the political market a muted attention to relevant information. Their purpose is dominated by entertainment in one form or another or by a more or less explicit devotion to a political creed. A perceptive articulation of budgetary, regulatory or monetary problems finds few buyers on the media market. There are, as in the political market, always some exceptions. But they do not represent the broad pattern dominating the media or the political market. The interaction between the two markets reinforces the disinformation process which lowers the pressure for a relevant accountability of policymakers and legislatures. And a lower accountability entrenches the inflationary bias even more into the political process. It also entrenches even more the spreading tentacles of a growing Leviathan.

The intelligentsia, as *Schumpeter* noted in his classic study of "Capitalism, Socialism and Democracy", moves with an ambivalent role in this process. It provides the themes on the media market and supplies the emotion controlling buzz-words and word pictures. The intelligentsia appears with the claim to grope for a critical examination and search for an assessable truth. This claim represents indeed a potential ever present. But an important strand in *Faust's* story conveys to us basically the ancient theme of a "trahison des clercs", the betrayal of the intelligentsia of their claims for access to power and influence on the political market. The intelligentsia willfully offered over the centuries its services for the disinformation so usefully marketed by the political apparatus. The most sinister part of the story refers however to the intelligentsia's not infrequent ability, less frequent among professional politicians, to justify its committed disinformation in terms of a parochial state, beyond the socio-political ruins of the present society, with their advice and operation in the media and political market.

The lines of my argument were unavoidably tightly drawn without the necessary qualification and the important nuances still to be observed in our societies. I deliberately drew the lines with some harsh definiteness beyond my sense of assurance in this matter. It is my hope that my presentation may stir some thoughts about our road. My theme was essentially simple. Permanent inflation appears as the syndrome of a pervasive political crisis of our

societies. It reveals a socio-political process moving us ever closer to Leviathan, i. e. the monster behind *Faust's* vision and *Mephisto's* artful help.

Are we condemned to march this road? The prevailing shades and nuances do offer us fortunately opportunities and hope. We may also be told that *Mephisto* ultimately failed. *Faust* was redeemed, a redemption I never could understand, however. But this may be the crux of any redemption. Still, redemption applies to an individual person and his soul. We cannot rely on the hope that the socio-political process will somehow encounter a redeeming redeemer. Such redeemers without fail are servants of Leviathan. Whatever needs to be done we will have to accomplish it. We also accomplished, with our past policies and actions, our present state and current trend. The institutional changes required to break the ongoing process and reverse the grasp of the political apparatus on our lives have been discussed by many scholars deeply concerned by the survival of a free and open society. The crucial conditions in all these endeavors involve some structuring of the political order which effectively limits the range of political action again. Man's resourcefulness may yet find a path, perhaps in a later future only. But man, after all, with all his dubious dimensions, is more remarkable and potentially more meaningful than the miserable and empty creature Faust really was.

## Summary

### Mephistopheles and Inflation

*Karl Brunner* died on May 9, 1989 in Rochester, New York. Prof. *Michele Fratianni* of Indiana University, while researching Brunner's academic life, found the unpublished paper "Mephistopheles and Inflation" which he submitted to *Kredit und Kapital*. The paper deals with one of Brunner's favorite research themes: money, inflation, and public choice. The structure of the paper goes as follows. Inflation is mostly a monetary phenomenon. Money is power. The Faustian Mephisto all too well understood this power when he proposed that the Emperor back his paper money by the unknown and buried treasures of the empire. Modern democracies have improved on the Mephisto's scheme only technologically. Politicians resort to inflation because it embeds a lower cost than either cutting expenditures or raising tax rates. Permanent inflation reflects a pervasive political crisis of modern societies and pushes us closer to Leviathan.