The Myth of the Shrinking Dollar

March 21st, 2011 at 6:29 pm Kenneth Silber | 38 Comments |

Introducing a new video series about monetary policy, Daniel J. Mitchell of the Cato Institute writes that the Federal Reserve has a "dismal track record" since its creation in 1913 and cites this figure:

> *Perhaps the most damning statistic is that the dollar has lost 95 percent of its value since the central bank was created.*

This "most damning statistic," much touted by central-banking opponents and gold-standard enthusiasts, is derived by compounding all the inflation that's occurred since 1913. The trouble is it's a figure that's suitable only for some Platonic realm of economic statistics that have little to do with life on Earth.

Let's consider how your average Joe Platonic might have lost 95 percent of his wealth as a result of 98 years of inflation. Joe wandered into a cave in 1913 carrying his entire life savings of $100 in cash. He fell into an icy pit and slumbered in deep hibernation until last week. He then returned, shivering, to civilization and found to his horror that his $100 —a respectably middle-class monthly wage, he recalls — is now what minimum-wage employees get for less than 14 hours of work.

Importantly, during his years of hibernation, Joe received no interest on his savings, owned no other financial or non-financial assets, earned no income and owed no money to anyone. Thus, he benefited zero from economic growth, compound interest or inflation's erosion of debt burdens. Also, being an old-fashioned guy, he has no interest in ever buying any new technology or product that didn't exist in 1913. He is unimpressed that, say, a $5 calculator can outperform a roomful of hand-cranked machines.

None of this means inflation is a good thing or even a trivial thing. It can be very harmful, certainly when it reaches elevated levels. But its impact has to be understood in the context of overall economic conditions, including the risks of deflation. Consider that Joe Platonic would be just about the only person to unambiguously benefit from protracted declines in prices, as he would have no worries about his possessions or labor becoming less valuable in dollar terms, or about his debt burden increasing.

Complaining that "the dollar has lost 95 percent of its value" since 1913 overlooks crucial differences between now and then: that today's inflation-adjusted incomes are vastly higher than in 1913; that people today typically spend far lower percentages of income on basic necessities such as food; and that many products readily available now were either highly expensive or nonexistent back then. It fails to recognize that real people, unlike Joe Platonic, tend not to hold their dollars in some existential vacuum.

Liberal blogger Matthew Yglesias responded to Mitchell's "damning statistic" with the following nonplussed rejoinder:

> *It's difficult to know how to make sense of the claim that the combination of mild inflation and compound interest means currencies decline a lot in value over giant time scales. If you assume governments should put a very strong priority on the interests of people who want to save large sums of money in shoeboxes, I guess this is a damning statistic. But it seems to me that the relevant issue is that real income in the United States has increased enormously over the past 100 years and that we've done better in this regard than most countries.*

All true, but I think Yglesias understates the problem with Mitchell's claim by evoking "people who want to save large sums of money in shoeboxes." The real victims of the dreaded 95 percent drop in the dollar's value are people who not only have shoeboxes of cash but who hold them for decades on end, own or owe nothing else, have no income and fundamentally have no connection to material reality. They are people like Joe Platonic: people who don't exist.

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