VII REGIONAL MONETARY STUDIES CONFERENCE

13th - 15th OCTOBER, 1975

ANTI-INFLATIONARY POLICY MEASURES

A COMMENT ON THEIR SCOPE AND EFFECTIVENESS

W.E. BARTON
Bank Of Guyana

CONF
RPMS
1975

ANTI-INFLATIONARY POLICY MEASURES - A COMMENT ON THEIR SCOPE AND EFFECTIVENESS

The financial crises of the recent past share a common origin with the global reality of prevailing inflation. Both are symptoms of financial mismanagement and instability within the world economy.[1] For much of the past decade, the major economies of the world were either seething under huge balance-of-payments deficits or basking in the sun-shine of temporary surpluses. Both experiences were equally without virtue for the world economy and were jointly contributory to the twin evils of recession and inflation on a global scale. In our small canoes on the vast sea of economic confusion and debate, we were engulfed by the shock waves of ocean liners endeavouring to find an even keel.

Seen in this context, inflation takes on the characteristic of a universal malady whose elimination demands a concerted effort at the international level. The small open economies of the Caribbean are by themselves only marginally capable of stemming the tide of imported inflation. Perhaps, in this part of the world, we may best be advised to abandon attempts at reducing inflation to tolerable levels and concentrate instead on policies of accommodation. One such policy may involve the simple technique of indexing which, incidentally, has found extensive application in the domestic sectors of the Brazilian economy.[2] Indexing of inter-

1) This observation is premised on the assumption that money income velocity is everywhere stable and, as such, limits the expansion of global demand essentially to the growth of international liquidity.

2) Less extensive applications are also observed in Europe and other Latin American economies.

nationally traded commodities is a natural extension of this process and an important thrust of the "New Economic Order".

THE GENESIS OF INFLATION

Before examining possible approaches for coping with the problem of inflation, let us look briefly at its origin and its place in business cycle developments. The phenomenon of inflation is one of excess and unbridled demand. It is easy enough to explain away its persistence by pointing to the ever growing pressure for increased social expenditures aimed at securing a better life for the masses of the world's population;[3)] by pointing to the excesses of military rearmament programs and the expenditures of protracted warfare. These expenditures were largely financed from the fiduciary issues of reserve centres. For years these centres fed the international monetary system with their national currencies through massive balance of payments deficits, which went largely unredeemed. They were making claims to the world's resources well in excess of their own contributions and, for a while, it seemed that their claims were going to be in perpetuity. As if to reinforce the emerging pattern, the international community, acting through the agency of the International Monetary Fund floated roughly 10 billion SDRs into the system. The foundations had been laid for a massive build-up of inflationary pressure. There was simply too much money chasing too few commodities. As mentioned earlier, the quadrupling of oil prices within recent years merely added fuel to an already well kindled fire.

3) See Irving S. Friedman, "Inflation, Recession and Growth", in Zahid Hussain, Memorial Series - No. 1 (State Bank of Pakistan, March 1, 1975).

A Mixture Of Old And New Approaches

International Considerations

It appears that the demand for the world's resources is growing at a faster rate than the pace at which these resources are being exploited. The lag in exploitation is abnormal only in the degree to which it exists. The constraint is not so much the availability of resources as the resolve to exploit them. There is need for a global re-ordering of priorities to affect a new relationship between the investment and consumption components of total expenditure. Investments must comprise an ever increasing share, if capacity is to keep abreast with demand, if recession is to give way to recovery and, if inflation is to be effectively controlled. To the extent that cost-push factors are involved, there must also be universal restraint on wage and price increases. In this regard, indexing can prove most beneficial to the world economy despite the formidable administrative difficulties which its imposition must pose.

There ought to be a concerted effort to achieve a less inequitable distribution of the world's resources through arrangements involving extensive application of commodity indexing and multilateral currency issues (viz. SDRs) which, without being inconsistent with the need for liquidity control, recognise the aspiration of the developing world. Both arrangements suggest accommodations to the eroding impact of inflation. Ideally, the first should halt the deterioration in the terms of trade of primary producing countries. The second should provide a redistributing function, so that poor nations can have access to resources, well in excess of their own national endowments. Together they should ensure that global inflation

does not achieve a lasting transfer of resources away from the developing world.

The reserve centres must become increasingly more conscious of the global consequences of their fiscal policies. The urgency of this need is emphasised by the futility of current efforts to free the world's monetary system from its dependence on the domestic note issues of these centres. Consciously or not, proposals for international monetary reform have as their prime objective the restoration of world stability. If SDRs are to replace national currencies as the main reserve asset, the IMF will be enabled to control world liquidity in much the same way as central banks regulate their domestic money supplies. Liquidity could then be advanced commensurately with the volume of international trade, instead of as a consequence of financial mismanagement in the reserve centres.

What is obviously more problematical is the simultaneous occurrence of inflation with recession on a global scale. The answer is nowhere achievable in conventional theories of business cycle analysis. In the past, it was felt that strong temporary inflation was almost invariable, associated with boom conditions. Excess demand stimulated capacity expansion, and eliminated the forces of recession.

Many economists attribute this curious turn in association to cost-push factors, such as the precipitous increases in oil prices since January 1973[4). Although cost-push inflation is certainly a phenomenon of some significance, it must be noted in all fairness, that the inflationary spiral was well on its way prior to the oil crisis.

4) Cost increases are only partially transmitted into effective demand, and, as such, are inherently growth retarding.

National Considerations[5)]

Our concern for world stability is justified by the gaping openness of our economy. With a marginal propensity to import in excess of .70. Guyana is wide open to the full blast of global instability. Consequently, the solution to our problems with inflation must lie first and foremost with a restructuring of the world economy. However, as we seek acceptable solutions in international forums, we must in the exercise of our social conscience, continue to treat the symptoms of inflation.

5) It is not abundantly clear what proportion of locally generated increases constitutes a reaction to imported inflation. The coconut vendor, for example, who is motivated to adjust his prices upward, because he has to pay more for cooking-oil, split peas, flour, etc. may be enabled to do so, because of the substitution and income effects of external inflation. Consumers faced with more expense imports, are likely to substitute coconuts. In addition, higher export prices, resulting in higher incomes also exert a stronger demand pull since, at each price level, consumers will demand a larger number of coconuts (implying an upward shift in the relevant demand curve). The vendor is enabled to raise his per unit price profitably. This would have been impossible in absence of the initial disturbance in the price structure, viz. the advance in import prices.

What is true of coconuts is also true of all domestic produce. Seen in this context, mark-ups become an integral part of the profit maximization process.

World inflation, therefore, changes demand conditions which make mark-ups not only possible, but highly profitable. The Producer may be motivated by higher costs or reduced profit margins, but the enabling factor is simply the change in demand conditions. In small open economies, therefore external influences loom oppressively too large.

Already, subsidies extend to such basic necessities as food, education and health. Marginal tax concessions have been instituted; price controls have been rigidly enforced; cheaper sources of external supplies have been explored and production has certainly been given its pride of place. Hopefully, future strategies would not overlook the value of a comprehensive and well conceived program of indexing. Of course, individual nations are not unbounded in their attempts to curb inflation. Anti-inflationary policies are effectively constrained, both in their degree and scope by balance-of-payments considerations. External imbalance, like inflation, is symptomatic of economic instability and, as such, cannot be an acceptable alternative to the latter. Yet, the majority of proposals, designed to control inflation or to seek some accommodation to it, suggests a preference for current account deficits. Subsidies, tax-cuts, wage-price indexing, all add to domestic expenditure and to the potential for balance of payments disequilibria.

Obviously, there is room for trade-off. Short-run deficits which are consistent with the goals of reserve management and which aid the process of growth and internalization should surely be encouraged. However, if such deficits are generated merely to finance acceptable levels of consumption, they become cancerous within the system.

SUMMARY & REVIEW

The paper reiterates and emphasises the inability of small open economies to reduce, significantly, the pressures of their own inflation. In this regard they are limited by the need to provide for long-run equilibrium in the external sector; which implies, in turn, long-run equality between aggregate supply and demand, between national income and expenditure and between resource generation and use. The need to balance the national accounts over time will, in the final analysis, constrain Governments in their attempts to alleviate the worse consequences of inflation. Yet, within that constraint, Governments may affect a more equitable distribution of available resources.

Our current experience with galloping inflation emanated essentially from the pressures of excess world demand, which appear to have been encouraged by financial mismanagement of reserve centres. Cost-push factors, (particularly the quadrupling of oil prices since 1973) certainly exaggerated the malady and explain, at least partially, the accompanying economic slump.

The recognition of the global character and origin of inflation, suggests that the sclution must lie in a concerted international effort. One obvious approach is to place the issuing of world liquidity under multinational control. If accepted, SDRs will replace national currencies (particularly the US dollar) as the dominant form of international reserves. Significantly also, the problem of international monetary instability will have shared a common solution with the equally pervasive evil of inflation.