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INFLATION AND ITS IMPACT ON SOCIETY

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For my purpose I want to define inflation as a persistent and more or less substantial decline in the value of money. Changes in the value of money are measured by changes in price index figures - or, in other words, by changes in price levels - for these indicate the change over time in the total amount of money paid for a certain basket of goods. I do not propose to make a contribution to the more intricate aspects of monetary theory. This would involve a discussion - for instance - of changes in price levels which do not actually represent changes in the value of money. Examples would include purely statistical changes - thrown up by the method applied in computing the relevant index figure - and price level changes caused by changes in the terms of trade, either between sectors within one national economy or between several national economies. None of these problems will be considered. I shall, I regret to say, only concern myself with less subtle aspects. That is why I have chosen a simple definition: a persistent and more or less substantial decline in the value of money.

The use of money makes it possible to replace a necessarily primitive economy based on barter by an efficient economy based on division of labour. In our society, money has two functions of fundamental importance. It serves as a unit of account and as a means of payment. As a unit of account it enables the virtually infinite number of value relationships between all the economic goods produced to be reduced to a straightforward pattern. It allows all participants a clear view of the economic process as a whole. In the economic universe, the unit of account is the one fixed point - the Archimedean point, one might say. Individual prices may change; the unit of account, given normal circumstances, is immutable.

Sound money also serves as a means of payment. In that function, money is the concrete representation of the abstract unit of account. In an extremely inflationary environment, as in Germany during the years following the First World War, the unit-of-account function is eroded first. People base their calculations on other units (foreign currencies, cigarettes, etc.). In this way the two functions tend to be severed. In a subsequent stage, even the means-of-payment function may waste away. In that case a money-using economy is gradually replaced by a (primitive) barter economy.

Although in theory money is thus a neutral and efficient lubricant to oil the wheels of a smoothly running economy, it may in practice become an independent source of disturbances. Inflation - which is our subject today - is the most important of these disturbances. Money translates the individual value relationships between goods and services, which may be regarded as relative prices, into absolute prices. If the actual use of money does not affect these relative prices, it will not affect the two basic processes of the real economy - allocation of productive resources and the distribution of factor income. The level of the absolute prices is then irrelevant.

An economy in which money fulfils the described neutral function with regard to the real economic processes is characterised by the uninterrupted flow of the available quantity of money through producer and consumer households. The national income in money terms is generated during the production of the national income in real terms and is simultaneously and continuously spent by the income recipients. The procedure is not unlike the blood circulation in the human body - an uninterrupted process of distribution and collection. In this neutral situation, nowhere is additional money pumped into the circular flow or part of the circulating money siphoned off. The amount of money in circulation is sufficient - no more and no less - to maintain production and consumption at the prevailing price level. Only if production expands owing to an increase in the employed labour force or to a rise in productivity, or both, does a corresponding amount of new money have to be injected into the economy to avoid "anaemia". Included in the circular flow is the savings and investment circuit, by means of which economic units transfer sums from the available money, through the existing money and capital flows, to other units, who spend them. The government participates in the circular process by levying taxes on the economic units and thus acquiring part of the national product. An open economy is linked to the outside world by the sluice gates of its balance of payments. It does make a fundamental difference, however, whether the domestic and foreign circular flows are linked through fixed exchange rates or through exchange rates determined by free market forces - or any of the mixed systems one can think of.

Inflationary disturbances will occur if somewhere in this cycle more money than specified above is injected. Additional demand, which does

not derive from current production, is then created for goods and services. This demand, however, cannot be satisfied in real terms; it is a case of "too much money chasing too few goods". Room is forcibly created by price rises, whereby a part of current production is bought up by those people who, having injected extra money into the cycle, are in a position to exert this extra demand (demand-pull inflation). The simplest form of inflation is provided by a swelling flow of money and a rise in prices.

A somewhat deeper analysis is required for a clearer understanding of this phenomenon. What circumstances can in practice cause a money stream autonomously to overflow its banks, and how is such a process initiated? For the sake of simplicity, we shall begin by assuming a closed economy.

(1) The business community, encouraged by favourable profit expectations, wants to invest more than its available savings. In other words, as financing by way of the existing flow of income is not possible, the business community turns to money-creating banks. Money is then injected. The circular flow has been disturbed, and the effect on prices must be awaited. We have assumed an economy with nearly full employment, because where there is less than full employment the swelling flow of money will initially merely increase production and employment before prices rise.

(2) The government is unable to meet its expenses completely from taxation and long-term loans and must therefore resort to money creation by the banks, by the central bank, or by both.

(3) A slightly more complicated situation occurs when a rise in the wage level exceeds the increase in productivity. When these higher wages can no longer be financed from the lowest possible level of profits, firms will try to restore their profitability by raising their prices (cost-push inflation).

However, this process can take place only when there is sufficient monetary leeway. When this is not the case, or when any initial leeway has been exhausted, the process must be halted on pain of firms getting into financial difficulties, resulting eventually in stagnation in production and employment. More attention will be given later to the special problems which arise when wage and price increases, once they have reached a certain size, become irreversible because the concomitant decline in productivity and employment is considered unacceptable.

One may wonder what actually has caused inflation in the foregoing cases. Is it the propensity to invest, the political inability to raise taxes or moderate expenditure, or the trade unions' insistent demand for higher wages? The answer is not easy to find, as in each case the question may be raised what causes are behind the immediate cause. However, all three cases have one feature in common. They cannot arise or be maintained without a growing flow of money. In this sense inflation in all its variations is a monetary phenomenon. It could always be prevented by a restrictive monetary policy. It could always be terminated by adequately slowing down the growth of the money supply. Whether this is possible, or will meet with so many objections as to be unfeasible, is a problem that will have to be discussed in more detail.

To the three causes that have already been analysed within the supposedly closed economy, a fourth one may be added when taking into account international relationships. A separate factor often mentioned as a cause of inflation is the increase in prices of imported raw materials. Some caution is required, however, in postulating that this fourth cause is indeed an independent factor. The sharp rise in raw-material prices that occurred before the oil crisis in late 1973 was the result of the expansionary economic and monetary policies pursued in all major countries. After the recession in 1970-71, which for the first time since World War II occurred synchronously in virtually all leading industrial countries, the policies conducted set off an outright international boom, which did not fail to affect raw-material prices. This is a textbook example of demand-pull inflation. It is largely to monetary expansion that one must point as being the cause of it (just think of the Euro-dollar market).

The steep increases in crude-oil prices in 1973 are a clear example of price-setting by a monopolist confronted with an inelastic demand for his product. This causes a change in the terms of trade between crude oil and oil products on the one hand and all other products on the other hand. Such a change need not necessarily lead to a further overall rise in prices, provided the oil price increase is adequately absorbed by the policies of the oil-consuming countries. In particular they should avoid awarding wage increases to compensate for the specific rise in prices, which in each of the oil-consuming countries is felt as a deterioration in the terms of trade. If compensation <u>is</u> awarded, this may set in motion an overall process of price inflation - but then we have case No. 3.

Once an inflationary process has begun, no matter what caused it, it will have important consequences for the economy. Persistent and large-scale inflation can even have consequences in non-economic fields; it can affect a society in all its aspects. To appreciate this fully it is necessary to analyse inflation more closely. Perhaps this analysis will help combat a dangerous proposition which undermines the will (and thus also the ability) to fight inflation effectively: the proposition is that inflation is admittedly troublesome and a nuisance but that "we must learn to live with it". This attitude is sometimes reinforced by the argument that no cure can ever be really effective because inflation is firmly rooted in our modern welfare society. Inflation can, however, be analysed as to causes and effects. Only such an analysis can teach us how inflation occurs, where it leads, and what the ultimate cost is of <u>not</u> fighting it.

We can distinguish three stages in the inflationary process.

1) A relatively moderate inflation, which is expected to pass. The elasticity of inflationary expectations is less than 1. Confidence in the unit of account has not been affected. It is possible to speak of a "money illusion". Such a situation exists when the rate of inflation is not higher than about 5%. A simple term for this stage is "creeping inflation".
2) Inflation gathers pace and it is diagnosed. People no longer expect it to pass either wholly or even in part, yet it is not expected to get worse. The elasticity of inflationary expectations is 1. Although confidence in the unit of account has been dented, it is not really weakened. The upper boundary of this inflationary zone might be set at 10%. One may speak of "marching inflation".
3) Inflation accelerates. People not only do not expect it to disappear, they even expect it to intensify. Confidence in the unit of account is fundamentally impaired. The money illusion has evaporated and symptoms of a flight into goods are visible. The elasticity of inflationary expectations exceeds 1. The rate of inflation is 10% or more. Here we could speak of "galloping inflation".

To bring these zones somewhat better into focus we may not be too far out in supposing, by way of example, that Germany is moving back through the second zone and approaching the borderline with the first zone; that the Netherlands is somewhere in the border region of the second and the third zones and, hopefully, moving in the right direction; and that the United Kingdom is in the third zone with the border between the second and the third far behind it.

Naturally, the borderlines indicated are only an attempt to quantify the three danger zones. In qualitative terms, one might think of the trouble involved in beating down inflation. Where it is still relatively easy to cure creeping inflation, it already calls for considerable endeavour to reverse marching inflation. But to fight and defeat galloping inflation requires a supreme effort which can probably only be made if broad sections of the community are convinced that the cost of failure is infinitely higher than the cost of effective combat. We may perceive what the cost of failure is by considering what galloping inflation ultimately leads to. It is the hyper-inflation that Germany experienced after the First World War. The functions of existing money as a unit of account and means of payment are wasting away and the economy returns to the primitive level of a barter society. It needs no further elaboration to see that such a situation involves economic chaos, social hardship and political anarchy. We need only consider that German experience to have a graphic example ready at hand. In what follows I shall indicate how these various dislocations develop when an inflationary economy moves from one zone to the next.

The second zone provides an excellent opportunity for studying in greater detail the paths along which accelerating inflation leads to dislocation and derailment. For, at first sight, the situation in this zone seems to have attained a measure of stability. People recognise inflation as such. They expect it to continue at the same pace and they act accordingly - assisted probably by indexation. We also presume that interest rates incorporate the existing rate of inflation which, on the assumptions we adopted for this zone, is also the expected rate of inflation. In principle, the economic process develops as if there were no inflation at all. Under these circumstances, inflation in the second zone could run a more or less quiet course and need not deteriorate into its third-zone

version, were it not for the fact that the stability is only apparent. Present-day inflationary processes are dynamic and to a considerable degree they are cumulative. Once started, inflation tends to keep itself going and to accelerate of its own accord. It feeds on itself.

Why is this? At the beginning I gave a short analysis of the possible causes of inflation, namely the business sector that invests too much, public authorities who pursue inadequate fiscal policies, and wage-earners who get pay rises that exceed the improvement in productivity, all three cases conditioned by a growing money supply.

In practice these cases occur both simultaneously and consecutively, and very often they show interaction. The present high wave of inflation is a good example of such close intermingling of causes. As early as the second half of the sixties, the first symptoms of distinctly inflationary developments were visible. Most industrial countries pursued expansionary fiscal and monetary policies; labour markets tended to become overheated; and wage increases far exceeded the growth in productivity. All this led to a combination of demand-pull and cost-push inflation that caused most of these countries to have reached, or even crossed, the boundary between the first and second zones by the time the oil crisis broke. An additional factor that stokes up the fires of inflation is the strong tendency in our society towards ever higher taxation rates and social insurance contributions. This causes a restriction of disposable incomes and acts as an additional impetus for wage increases to exceed the growth in productivity.

It is, therefore, when the primary causes have lost their impact and do not recur, that the inflationary process does not run a more or less quiet course, as we just now assumed when we referred to the situation in the second zone. If in a demand-pull inflationary environment cost-push inflation sets in, this cost-push inflation shows a strong tendency to accelerate and to continue even after the demand-pull inflation has been stopped (mostly by restrictive monetary and fiscal policies). The cause of this dynamic development is the interaction between wage and price rises, an interaction that in turn is strongly influenced by wage-earners' expectations, which are raised and disappointed in endless succession. On the basis of expected price patterns they assume that the increment obtained in money terms will be translated into a certain improvement in real terms. When the increments are considerably in excess of the growth in productivity, disappointment is inevitable because prices turn out to be rising more

sharply than expected. The next wage increase will therefore be based on expectations of a faster price rise, and so on. The process may be reinforced by an increasing burden of taxes and social insurance contributions.

Pay rises that exceed the scope created by the improvement in productivity are an intrinsic part of the dynamism of inflation. This is obvious if we study the available statistics. In doing so, we should compare the rise in productivity - adjusted for changes in the terms of trade - with the rise in nominal wages per worker, adjusted by means of the GNP deflator.

We have thus reached the situation where inflation is careering ahead at full gallop. The third zone has replaced the second one. In many industrial countries the course of events has actually been as described. Although the higher oil prices were undoubtedly an extra stimulus, we should not overlook the fact that they were not the underlying cause. If, at the time of the oil crisis, inflation had been mild or almost absent, the effects of the oil price rise might have been absorbed without great effort. But the economic environment had already become unstable and was no longer able to cushion the heavy impact. (This observation relates to the consequences of the oil crisis for the rate at which prices are rising. The implications for international expenditure and balance-of-payments equilibrium would take us to the issue of recycling, for which I may refer to the Annex.) The repercussions of such an intensive cumulative inflationary development are severe. This holds for the economic, the social and the political aspects, as already mentioned. I shall now consider these aspects in some more detail.

It is obvious that the business sector is particularly sensitive to the consequences of an inflationary process once it has started as described. Profits are beginning to decline. Although in the first stages inflation of the purely demand-pull variety may still be beneficial to production and employment, the situation changes radically when it combines with an accelerating cost-push inflation. Industry then reacts by stepping up its investments aimed at substituting machines for relatively expensive labour (expansion of capital-deepening investments). At the same time, however, the propensity to invest for purposes of additional productive capacity diminishes (contraction of capital-widening investments).

Slowly but unmistakably a pernicious kind of unemployment appears. Pernicious, because it cannot be cured by simply stimulating demand; it requires a sufficient recovery of profitability, which is difficult and time-consuming.

The problems meanwhile accumulate. Initially, investments are financed from industry's own resources, loans floated in the capital market and bank credit, but gradually financing runs into obstacles. Funds for internal financing are eroded by the ever-rising wage costs; suppliers to the capital market become more and more reserved. The maturities of funds offered in the capital market tend to contract (a clearly visible symptom of inflation), and banks reach the stage of being fully loaned up. In short, industry is increasingly facing problems of financing and liquidity.

Liquidity problems may be aggravated by existing taxation systems that tax profits irrespective of whether they are real or only nominal.

But there is more to it than this. The erosion of profits and the squeeze on liquidity are not evenly spread over the business community. Labour-intensive sectors may be hit harder than capital-intensive ones. Firms producing mainly for export are often affected in a different way from those aiming generally at the domestic market. Firms will always be differently placed, of course, even in a society with little or no inflation; for instance, higher wages that may be acceptable in terms of the average improvement in productivity measured nation-wide may be awkward for specific sectors. But within a sound economic environment such problems are absorbed and solved smoothly. The system is sufficiently elastic to cushion and even out the pressures. Inflation at full gallop is, however, too onerous. The normal relationships between the various sectors of industry are impaired. Economic life disintegrates. People begin to feel uncertain about the possibility for an economic system based on market forces to continue - an uncertainty, moreover, that is only too readily fostered by those who advocate a different social order of which they may or may not have any clearly defined notions.

These economic developments have social consequences. It is obvious that receivers of fixed incomes are hit to the extent that their incomes are not adjusted to higher prices. Many pensioners come into this category. It is not surprising, therefore, that in such a situation indexation is increasingly resorted to. This is not a way out, however,

for those who derive their income from bonds. Difficulties may arise if for one reason or another people have to sell securities, for many bonds with a relatively low coupon will only sell at a substantial loss, which may also be the case with shares. And there are still other sources of uneasiness. Rightly or wrongly, there is a general feeling of being counted out and of having to catch up with the others. People are tormented by expectations that are first aroused and then disappointed. They lose sight of their familiar landmarks. There is a general feeling of being defrauded by invisible forces.

It needs little imagination to see that such a situation must have political consequences. Firms in difficulty, the unemployed, all those who are disappointed in their expectations - they all turn to the Government. "Where is the Government?",is the catchphrase of the day. It appears that the Government is everywhere, but, according to the phrasemakers, with insufficient effect. A few examples of the way in which the Government is approached: Firms in financial distress ask for support. A multitude of facilities are devised for this purpose. Increasing numbers of firms, whole sectors even, are leaning heavily on Government aid. The problems are not confined to industry proper. Newspapers, political parties, churches of whatever denomination, they all ask for subsidies. The private sector seeks to pass its burdens on to the Government. A classic phrase runs "gouverner, c'est prévoir". Mendès France changed this into "gouverner, c'est choisir". By now it seems as if it might perhaps be more apt to say "gouverner, c'est subventionner".

The Government is thus faced with a serious situation. Must it insist on controlling those firms which it helps? Must it become a substitute for a failing capital market and a loaned-up banking system? Must it acquire shares in failing companies? How must all this be financed? Higher taxes could have an adverse effect. There is a risk that the economic system will move into a twilight zone, a half-way house between a social order based on private enterprise and a collectivistic economic system.

To summarise: inflation, in full gallop, causes disintegration and arouses social resentment, undermining the proper working of the political system and thereby threatening the very roots of democracy.

Inflation, as seen in the world of today, is the result of a number of causes which - interacting - have made it dangerously explosive. This analysis points to what must be done, in principle, to stop this development.

The prescribed therapy is closely related to the three inflationary zones already described. Every inflationary process, no matter what its origin, is conditioned by a swelling flow of money, which in turn is made possible either by money creation or by the activation of liquidity accumulated in the past. (Money is created by the money-creating banking system at the initiative of the business community or of the Government). Thus every inflation can be prevented and stopped by a restrictive monetary policy, even though the availability of "old" liquidity may mean that this process will take some time because this "old" liquidity must be absorbed before a policy of tight money can take effect. The economic and social consequences and thus also the political repercussions will, however, differ widely from zone to zone.

This is because wages in our society rise, but do not fall as they did in the past. This is also true of the general price level (not, of course, of individual prices). Thus when a restrictive monetary policy is applied in an attempt to prevent wages and prices from spiralling further upwards, it means that the resulting volume of money will be too small relative to the rising level of wages and prices, so that production and employment are adversely affected. Symptoms of stagnation (stagflation, slumpflation) become evident. It is therefore of vital importance that under these circumstances monetary policy should be complemented either by a deliberate wage and price policy or by clearly defined measures to influence wages and prices in a more general way. Enforcement by law should not, however, be necessary. The same end can also be achieved through consultations between the Government and the business community aimed at voluntary restraint so as to deprive wage and price increases of their cumulative effects. The guideline is that, generally speaking, the nominal wage increase deflated by the price increase should be in line with the growth in productivity (adjusted, if necessary, for changes in the terms of trade).

When inflation has progressed deep into zone (3) it is to be feared that only a rigorous wage and price freeze can provide the breathing space needed to fight inflation effectively.

We must realise fully that the forms of therapy mentioned must deprive inflation not only of its impetus but also of its momentum. Not only must the progression towards and within zone (3) be stopped, but the return to zone (1) must be engineered. To put it briefly: in order to break the impetus it will be necessary to change the ratio between wage and price rises; to reduce the degree of inflation a parallel reduction will be needed in wage and price rises. In all cases the success of the therapy applied will depend also on the use of adequate monetary and fiscal policies.

A few words should be added about the concrete situation in many countries. Widespread structural unemployment does indeed exist, as we have already explained. Inflation has also resulted in endogenous processes which have led to the classical downward trend in the trade cycle. The policy which must be pursued must not only put a brake on inflation, it must also stimulate the economy. This will need a very careful mix of monetary and fiscal policies. Fiscal policy must provide the stimulation, while monetary policy must ensure there is no opportunity for inflation to raise its head again during this new period of growth. The Government's borrowing requirements (substantially increased because of the stimulative policies) must therefore be met by capital market borrowing and not also by money creation. This is of great importance for the United States especially. Fiscal policy is necessary to stimulate the domestic economy and thereby world economic conditions. Should the United States finance its borrowing requirements by creating too much new money, it might be wrong for the country itself and, because of the strategic importance of the dollar, for the world as well. The seeds of a new inflation might have been sown.

The possibilities of fighting inflation have been analysed above in terms of the instruments of economic and financial policies. However, the timely and effective use to which these instruments can be put is determined by what is feasible politically. Alas, it must be said that political inefficacy is a major barrier to fighting inflation effectively. In this respect things have not improved since the thirties. At that time politicians were unable to stop deflation; now in many countries they seem to be powerless to stop inflation. Of course, explanations can be found for this impotence. There is a deep and widespread feeling of discontent

with the economic and social order in which we are living and this means that the climate is unfavourable for governments to take the necessary measures. Measures are too long delayed, inflation proceeds apace and what would have been relatively easy in zone (1) requires a nearly superhuman effort in zone (3).

Seen in this light, the fight against inflation is a major political problem. It demands political leadership which is both able and prepared to convince the population that, however high the cost of combating inflation effectively, the cost of not doing so will be considerably higher. Ultimately the cost will be that the principles of private enterprise and of democratic government will not be able to survive. It must be possible to make this plain to those who do not desire a collective economy or advocate a political dictatorship. Those who want these things will not wish to fight inflation, a "complete" inflation being a bloodless revolution. It would be a good thing if at this vital point there could be a parting of the ways. In that case a fight against inflation might be effective - even in zone (3).