

ANTI-INFLATION POLICY

SYED MUNIR HUSAIN

University Lecturer in Economics

Anti-inflation policy refers to measures which can counteract inflation. The need for counteracting inflation arises because its effects exercise great detrimental influences on the economy of a country. It is for this reason that inflation has come to be considered an acutely disagreeable phenomenon. It may be mentioned that inflation may not be necessarily injurious under all circumstances but may be capable of mobilizing the industry of an economy especially when inactivity has become its cardinal characteristic. This does not extenuate the evils of inflation which, in view of their diverse character, have hardly retained any justification for its existence. The kind of inflation Germany witnessed in 1923 deserves unreserved condemnation. The disasters of inflation have been so great that economists in the present century have made notable efforts in finding out measures for controlling it. The nature of anti-inflationary policies cannot be readily appreciated unless the effect of inflation and the term is precisely comprehended.

Inflation is an economic term which cannot be easily defined. Most of the economists have not taken the trouble to define it and have tried to explain it by means of illustrations or by an analysis of its implications. The general idea conveyed by the term is not a point of controversy and is not at variance with its common meaning. Inflation in the widest sense is said to have occurred when the supply of money and bank deposits increase relatively to the demand for media of exchange. In simple words this signifies excess or superfluity of media of exchange. Supply of money consists of credit and currency combined with the velocity of circulation. Demand for money is a vague term and is generally interpreted as needs of trade or economic activity. To ascertain the existence of inflation it has to be seen whether the price level has risen or not. If it has risen then it may provide a clue, but a rise in prices is not always an infallible symptom of inflation. This rise may be due to a rise in the average cost of production which cannot be considered inflationary. Similarly inflation can exist in spite of stable prices. If the cost of production has decreased on account of scientific and technological developments and the prices have remained

stable as was the case in America during 1923 to 1929, there also inflation can exist. Hence inflation can either result from an increase in the quantity of money, the quantity of goods remaining unchanged; or a decrease in the quantity of goods, the quantity of money remaining unchanged. The more variable factor of these two is the supply of money.

From the point of view of policy, saving and investment theory constitutes an improvement upon the above analysis in as much as it point out that excess of investment over savings after the stage of full employment has been attained will raise the price level which will create a situation identical to inflation. Before the stage of full employment, increase in the supply of money will be offset by increase in production. A stage is reached when production becomes stable but the volume of money investment continues to rise. This later development is identified as inflation. Pigou has stated that inflation exists when money income is expanding more than in proportion to income earning capacity.

So far as the effects of inflation are concerned they are felt unevenly by different classes of individuals. The debtors in general obtain greater advantages during inflation because they are not only in a better position to redeem their debts but also they make these payments in money whose value has depreciated and this represents a lesser sacrifice. This profit to the debtors constitutes a loss to the creditors. The creditors stand to lose during inflation. Although they receive the same amount of money yet this money represents a reduced command over goods and services.

The farmers and businessmen reap great profits during inflation. The prices of agricultural goods increase at a very fast pace and the farmer is able to maximize his profits; this is most true when the prices and costs paid by him are lower than the prices and goods he sells. The profits of the farmer may be unevenly distributed among all those who contribute their share in the production of agricultural goods, and as such some members of the rural class may not benefit at all from inflation. If the land tenure system of a country confers proprietary rights on the landlords who get the land cultivated from the peasants and have a strong hold on them, then most of the increased income will fall to their share. In such a case the position of the peasant may not be affected by inflation.

Under inflation the businessman is bestowed with great favours because a rise price level induces him to produce on a large scale and thereby he increases his profits. But a more important factor responsible for his increased gains is the disparity in his cost of production and the prices of goods he sells. Wages tend to lag behind rising prices, and the cost of production is slow to

catch the rapidly rising prices; the greater the difference between the costs and the prices, the greater will be the profits of the entrepreneurs. On the basis of increased profits the entrepreneurs develop strong optimistic propensities which further prompt them to enlarge production and make additional profits.

The wage earners are subjected to great economic misery and severity. The greatest impact of inflation is on this class because it stands to lose a great deal on account of increased prices which reduce the purchasing power of its members. In countries where the trade unions are strong and are able to obtain higher wages there the effects of inflation may be partly neutralized but otherwise the standard of living of the labourers is bound to go down, and there does not exist any safeguard against the peroration of the economic lot of a very important class of the country.

Apart from the labourers the fixed incomists and the salaried persons also incur losses and suffer from the malady of reduced real income. But their plight is not as great as that of the labourers because the former may absorb the shock without foregoing the consumption of necessaries on account of higher incomes. The wage earners have already a low standard and a further fall in their real income will render them destitutes.

These are the effects which inflation exercises on the various groups of people; but this does not imply that its effects are confirmed only to this extent. On close analysis other implications of inflation are found to be related to the stability of the economy of a country. Its greatest implication is that it creates conditions for the emergence of a slump in the economy. When prices start rising consumption is adversely affected because the real income of people is reduced. The redistribution of income is in favour of the moneyed class and against the wage earners. The demand for goods emanates from the wage earning class and if this is reduced it will affect the prices of goods produced. As a result of this consumers demand is not able to absorb the full output of consumer goods. This situation may culminate in a crash of prices and a downward movement of prices may be initiated.

The volume of investment is also made vulnerable to inflation; rising prices contribute to higher profits, and this actuates the producers to expand investment which involves the employment of new labour. Increase in employment creates demand for more goods and this leads to a further increase with volume of investment. But when the prices rise too high and the consumers are unable to purchase all that has been produced, the producers will become panicky and may decide to stop further investment. This period is the most critical for the entrepreneur, and if at any time they become doubtful about the

prospects of business they will proceed to disinvest and to reduce the size of their firm. This will mark the approaching depression.

In a similar fashion inflation will produce deflationary effects on an open economy by influencing foreign demand for its goods. If a country gives employment to its nationals by producing goods for the foreign markets then inflation would reduce the foreign demand whose repercussion would be left on the export industries. The existence of slump in some industries will contribute to a depression of domestic business activity.

It is apparent therefore that inflation is the primary cause of a depression in a country. It is for this reason that inflation is deprecated and is considered to be incompatible with the stability of a country's economy. For stabilizing economic activity it is essential to control inflation because otherwise the economy cannot be insulated against the occurrence of depressions which reduce the national income. It is apparent that the magnitude of the depression is partly determined by the magnitude of the inflation which has preceded it. Therefore if inflation can be controlled in time, it may be possible to minimize the destructive tendencies of the ensuing depression.

The main objective of remedial measures adopted to control inflation is to reduce aggregate monetary expenditure. This can be best achieved by proper concentration on both monetary and non-monetary measures.

MONETARY MEASURES

The determination of effective monetary policy falls within the scope of the activities of the Central Bank. The most important function performed by a central bank is that it regulates credit in accordance with the economic requirements of the economy. The economic requirement during inflation is a drastic quantitative control of credit. In the past most popular weapons of credit control have been the discount rate policy and open market operations. Whenever the prices soared high the central bank would raise the discount rate and try to create condition conducive to the contraction of credit. But the success of this policy presupposed the existence of an organized money market which would facilitate a rise in the money rates prevailing in the country consequent upon a rise in the discount rate. Before the first world war this instrument of credit control was quite effective but after that its significance gradually declined owing to the great complication which appeared in the economic systems during the inter war period.

Open market operation is another instrument of credit control which can check inflation. The central bank can contract credit by selling securities in the open market. If the magnitude of the open market operations is large it may

be able to withdraw a large amount of cash into its vaults. In such a case the commercial banks will be forced to contract their deposits; this will curb inflation partly. This policy for its direct impact on the monetary structure and greater effective control of credit, has obtained priority over the discount rate policy. But the success of open market operations is also based on a set of assumptions; if any of the conditions required for its successful execution are missing, the policy may not check rising prices at all.

To these weapons of monetary policy some other instruments have also been added, such as changes in the minimum cash reserve requirements and regulation of consumer credit etc. In order to improve the central banks' technique of controlling prices it has to be entrusted with greater powers. One of the powers which Central Banks have received in some countries from their Governments is to change the cash requirements to be maintained by the commercial banks with it. During inflation the central bank can increase the ratio of the cash reserves to be maintained by the banks and thereby impose severe restrictions on their ability to create credit. This weapon is an effective instrument because it will directly lead to a contraction of credit.

Anti-inflationary monetary policies may not succeed in checking inflation especially when prices have risen as a result of non-monetary factors. In the past when cyclical fluctuations were attributed to changes in the supply of money great emphasis was placed on reduction in the quantity of effective money for controlling inflation. The practical conclusion derived from this accentuated analysis of inflation was to confine all measures to monetary adjustments. But this policy is inadequate to check inflation because the part played by non-monetary factors is important enough not to be ignored. This indicates that for instituting an effective control over rising prices, monetary policy has to be supplemented by non-monetary measures. Monetary policy itself is subject to great limitations; A central bank may not always succeed in forcing a contraction of bank credit; there may be many neutralizing forces operating in the economy which are not within its control, for example, the liquid position of a country occasioned by a persistent favourable balance of payments may place the commercial banks in a position to frustrate the policy of the central bank. In view of the limitations of monetary policy some stress has to be laid on the adoption of non-monetary measures without which it is exceedingly difficult to check inflation either effectively or in time.

NON-MONETARY MEASURES

Reduction in Expenditure

The Government can devise a suitable fiscal policy to counteract inflation. The first thing it should do is to reduce its own expenditure to offset increase in

private spending. The size of Government expenditure has some relationship with economic activity. Government expenditure should be deliberately reduced to withhold fresh supplies of money going into circulation. But government expenditure is not very amenable to elastic changes required by inflation. There is a limit set by expenditure on defence, foreign affairs, internal administration etc. below which it cannot be reduced. Reduction in government expenditure becomes much more difficult when the country is confronted with contingencies and when it has to strengthen its defence in order to meet the situation created by the present international discord. In spite of these obstacles government expenditure is capable of being contracted and as such may be relied upon to be used as an instrument for counteracting unregulated private expenditure.

Taxation

The second fiscal measure which can help in controlling inflation is the adoption of taxes which reduce the incomes of those who have made huge profits. The tax structure of the country should be comprehensively adjusted to rising prices with a view to reduce spendable money. The introduction of high rate of taxes will increase the revenue of the state which can be productively utilized especially when the symptoms of depression have been identified. Great stress is being laid on surplus budgeting as a method of controlling inflation; surplus budgeting is bound to have salutary effects on prices because a part of the effective supply of money will be sterilized and will be rendered ineffective.

But an overall increase in all taxes may not be advisable. For example, if tariff duties are raised along with other taxes then a country which has a significant volume of imports will suffer a great deal and the benefits of intensified taxes may be neutralized by the high prices of imports. The desirable policy would therefore be the liberalization of tariff duties in order to increase the supplies of goods which may alleviate the general shortage of goods. Tariffs, as such, constitute an important exception to a policy of higher taxes for curing inflation.

Savings

Increase in savings can combat inflation because it will lead to a fall in consumption and investment. The peak of inflation is characterized by a phenomenal rise in investment and represents a basic discrepancy between saving and investment. Inflation can be checked if measures are adopted to decrease investment and to increase savings. So that an equilibrium is established between them at the point of full employment. There are two ways of increasing saving: The first is to create conditions which can attract voluntary savings. This can be achieved when a vigorous propaganda is conducted in favour of savings

and various institutions are created which provide facilities for savings to the public. The government can also resort to public borrowing on a large scale; if it finds that sufficient contributions are not made to the loans floated then the interest rates may have to be raised so that people may be induced to give loans. But this method of increasing savings is an unreliable one because there is the possibility that in spite of all persuasion and temptation the volume of savings may be inadequate to act as a deterrent to inflation. The second method is to resort to compulsory savings. According to this plan the consumer defers a part of his pay by buying saving bonds which are redeemable later on. One form of compulsory savings is the forced loan which was tried by Belgium, Holland, Czechoslovakia and Norway. The implications of all type of compulsory savings are the same: the main objective is to withdraw money which is otherwise spent on consumption or investment. But compulsory savings are considered undesirable in peace time as they involve coercion to which people may not readily submit unless they are convinced of the gravity of the situation. This, however, does not imply that a policy of compulsory savings must not be implemented if the people do not approve of it; the approval of the people or their disapproval cannot determine a policy of this nature; its implementation should be determined by the magnitude of the inflation and the expected benefit to be obtained from such a policy.

Overvaluation

An overvalued currency offsets inflationary pressures on the economy to some extent. In the first place its effect is to restrict the size of exports because their prices in the foreign markets have risen which cause a shrinkage in demand for them. More goods are at the disposal of the country. In the second place its effect is to increase the volume of imports because their prices fall and the demand for them increases; this provides a safeguard against the paucity of goods. In the third place the effect of an overvalued currency is to reduce the cost of production of those goods whose production depends on imported stock in the form of raw material or capital goods which are purchased at reduced rates. But overvaluation as an anti-inflationary policy cannot be persistently followed because it has its other economic implications such as the deflationary effects it produces which cannot be disregarded.

Increased Production

One of the most effective measures to check inflation is to expand production in accordance with the increase in the supply of money. This will lower prices and inflation will be eliminated. For the full utilization of resources a gradual rise in the prices will be feasible to induce the society to increase the volume of investment; there will be no sharp rise in prices so long as resources

are idle and are awaiting employment. If it is possible to stabilize prices when full employment is reached then the danger of inflation is contracted but if prices continue to rise beyond this stage then inflation has emerged and can be checked by increasing output. A programme of increased production must attach special importance to the production of inflation sensitive goods; if these cannot be easily produced in the home market then they can be imported on large scale from other countries. All measures should be tried to increase the output of consumer goods.

The existence of monopolies is inimical to a general anti-inflationary policy. Monopolies must be properly regulated if the plan of output adjustment is to be made a success. Another difficulty is the industrial strikes whose numbers should be kept at the lowest minimum during inflation. If strikes are not prevented then there are few chances to increase production. The Government should make all attempts to reconcile the interests of the workers with the interests of the employers, and it should not hesitate from enforcing regulation to execute the plan it has visualized. A comprehensive plan of increased production will have a highly moderating influence on the prices.

Wage Policy

There is a great need to regulate wages during inflation especially when the trade Unions in a country are a powerful body and can compel the employers to accept their demands. Higher wages demanded by labourers can be justified only when the cost of living has risen high; changes in the wages should be commensurate with changes in the cost of living. What may be stressed most in connection with a suitable wage policy is that if before inflation the wages were considered just then during inflation wages should rise only to the extent to which prices have risen because if the former rise more than the latter then the cost of production will increase.

Price Control and Rationing

These two measures have been frequently practiced by many countries in the past but they became prominent during the second world war. The object of price control is to fix a maximum price for commodities in order to prevent prices rising beyond that level. Price control is a welcome measure when profiteering and black marketing are rampant. In order to operate price control successfully many countries imposed heavy penalties on those who violated the price control regulations.

According to Keynes price control is a poor anti-inflationary instrument because it fails to bring about equilibrium, namely, the needed balance between purchasing power and available output. He feels that price control increases

the pressure of consumption and merely leads to shop shortages. Keynes advocates a reduction in the purchasing power by means of taxes and forced savings, and he wants to allow the consumer to purchase what he likes with the reduced purchasing power at his disposal.

The main object of rationing is to divert consumption from those goods whose supplies are inadequate for the society's requirements. If the articles in shortage happen to be necessities then this system provides a basis for ensuring equitable supplies to all members. In the absence of rationing the prices of these goods would be rise very high, and it would be beyond the means of the poor to consume them. Rationing, therefore, finds for itself an ethical justification under conditions of inflation. If the state can guard against the dangers of corruption and inefficiency then price control and rationing can be relied upon to play their part in an anti-inflationary programme.

The non-monetary measures discussed above illustrate that if policy is exclusively confined to monetary measures then inflation may not be checked. To make an anti-inflationary plan a real success it is vital that the policy formulated by the central bank of a country must be very strongly supplemented by fiscal and non-monetary measures.

BANK OF ENGLAND

A woman called at the Bank of England and asked if she might consult some one about her war loan holding. "Is it a case of conversion, or redemption, Madam?" "Conversion, redemption," faltered the woman. "Ere-pardon me is this the Bank of England or the Church of England."