W A Wijewardena: Why worry about inflation?

Speech by Mr W A Wijewardena, Deputy Governor of the Central Bank of Sri Lanka, at the Central Bank of Sri Lanka, Colombo, 25 May 2007.

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Inflation, a continuous and steady rise in the general price level, is, by any standard, the public enemy number one. By the same token, hyper-inflation, an increase in the general price level to a very high level within a very short period of time, is a killer, akin to a mass destruction weapon. Mr. Gideon Gono, Governor of the Reserve Bank of Zimbabwe, a country with an inflation rate of more than 3700%, equated his country's inflation to an economic HIV, a situation where people would die en masse. This reference eloquently amplifies the gravity of the cost of inflation which a country has to bear.

Why public enemy number one?

From the point of view of economics, there are usually two declared public enemies: inflation and unemployment. Of the two, inflation ranks higher. This is because inflation hurts everyone alike: bankers, businessmen, workers, consumers and so forth. You cannot escape it unless you are smart enough to beat it by raising your income faster than inflation. In contrast, unemployment which is also a serious problem, disadvantages only the unemployed. That category is only a segment of the society. Hence, inflation is a bigger public enemy than the unemployment. When one compares it with other public enemies like drug abuse or terrorism, one would still find that those issues would also affect only a segment of the society at any given time. Since inflation affects everyone and people have limited prospects of escaping it, it is considered as the public enemy number one.

Some amusing stories about inflation

In the recent history, there have been many countries which have been hit by hyper inflation. Of them, the most prominent case has been the hyper-inflation in Germany after the First World War, where inflation accelerated to 1,000,000 % per annum. Other noteworthy examples are Bolivia (25000 % p.a.); Russia (2000 %); Israel (1500 %); Turkey (again 1500 %) and currently Zimbabwe (3700 % and still rising).

When prices rise at these high rates, the first casualty would be the currency of the country. No one would like to accept the domestic currency, because its value would fall by the minute. Instead, people would start to accept other types of hard currencies like the US Dollar. If there is a shortage of those hard currencies, people would invent their own currencies. In Germany, with that hyper-inflation in which prices rose by 2 % every minute, German Mark ceased to function as money. Instead, people started to use cigarettes, chocolate bars or empty bottles as the medium of exchange.

Then, there is the story of those two brothers who inherited a sizeable wealth from their father. One being a reputed investor used his endowment to build a substantially large portfolio of investments. The other was a drunkard and used the entire amount for drinking. Thus, he ended up with a houseful of empty bottles. The story goes on saying that Germany was hit by hyper-inflation reducing the value of the entire investment of the son who adopted prudential policies to zero. But, the drunkard became a millionaire overnight, because his empty bottles now became money.

A similar amusing story relating to Bolivian inflation in mid 1980s takes a different form. Since prices are rising at such a high rate, it became necessary to negotiate and agree on a price before undertaking even a very simple transaction. The story says that before a person takes a haircut, he would agree a price with the barber. But, halfway through, the barber would stop cutting the hair and renegotiate the price. That was because by that time, hyper inflation has raised the prices to a still higher level. As a result, the original contract price no longer becomes valid.

Economic costs of inflation

The above stories, though invented to amuse people, teach us some very valuable lessons. First, uncontrolled inflations erode the confidence of people in the domestic currency. As a result, governments lose the control over money and fail to use monetary policy to curb inflation. Second, people move away from long term contracts and would be concerned only about the passing moment. Salaries, earlier paid monthly would become payable first fortnightly, then weekly and daily and finally hourly. It would entail a tremendous cost on the employers to meet the demand for paying salaries every hour. Similarly, all other contracts would also be very short term contracts. People would not think of the future, but only on the passing moments. This type of short-term behavior on the part of people would cause the economy concerned to collapse on itself due to a lack of long term commitments.

Inflation normally brings in several other irreparable damages to an economy.

In the first place, inflation discourages exports, encourages imports and widens the gap between the imports and exports known as the trade gap causing problems for the balance of payments and the exchange rate. If the domestic prices are higher, there is no reason for exporters to sell a product abroad. For instance, if inflation raises the price of a coconut to Rs 100 in the domestic market and its given price in the international market is Rs 50, an exporter would sell the product in the domestic market to gain the price advantage. Similarly, imports are encouraged, because of the lower price in the international markets than the domestic market. This is equivalent to imposing a tax on exports and giving a subsidy to imports.

Second, inflation favors borrowers and discourages savers, if interest rates are not adjusted to reflect the going inflation rate. This is because when such adjustment is not made, though the amount of money received by way of interest may be high, its actual real value is lesser and lesser than before. It is tantamount to the awkward situation where savers pay interest in real terms to borrowers. Thus, inflation contributes to enrich borrowers at the expense of savers. The high borrowings so encouraged would further fuel inflation. At the same time, the much needed savings flow would dry up retarding the long term development.

Third, arising from the same unadjusted interest rates, inflation discourages financial savings and encourages non-productive types of investments in real estate, gold, bullion and other types of precious metals. Bank deposits, stocks and shares are the main casualties, because their real value falls every year due to inflation. But, on the other hand, real estate and precious metals appreciate in value due to inflation. Hence, as an insulating measure against inflation, people would transfer their financial savings into such non-productive types of investments. But, for sustainable long term growth, the necessity is for savings in the form of financial savings and inflation would dry up that savings flow.

Fourth, inflation distorts the resource allocation function of an economy. For the market system to allocate resources among competing uses, a price expressed in terms of another price called the relative price, should change. For instance, if the price of carrots increases relative to the price of cabbages, carrots would become more profitable than cabbages. Hence, the farmers would concentrate on producing more of carrots and less of cabbages. But, when an economy is hit by inflation, all the prices would rise simultaneously, so both carrots and cabbages seem to be equally profitable. This would confuse the producers who would now be unable to make any choice between the two products. Hence, the much desired relative price change does not occur, when an economy has been hit by inflation. Instead, the absolute prices start to change and such changes do not provide the price signals for allocating resources.

Fifth, continued inflation distorts the balance sheets of companies, especially the balance sheets of financial institutions. Companies may record profits in nominal terms, but a large part of such profits are eroded in real terms by inflation. When profits are adjusted for inflation, companies would find that their performance has not been so spectacular as has been depicted by the amount of rupees they have earned. In fact, their real position has pushed them backward to a lower level.

Sixth, inflation very forcefully hits the vulnerable groups with a weaker bargaining power. Such categories include housewives, students, pensioners and workers whose salaries are not linked to inflation. It would lead to continuous agitation by these groups creating social and political dissension. The country, instead of using its resources for investing in long term growth generating projects, would have to spend its energy and resources for solving such social issues.

Thus, inflation is the unrivalled public enemy number one.

Who should take the blame for inflation?

It is ironical that practically everyone in the society should take blame for a continuously high inflation in an economy. This is because everyone, even in a very little measure, would have contributed to facilitate inflation to raise its ugly head. It happens when people of a country believe that they can have a higher standard of living without working harder or producing more.

Inflation in the long run is directly related to the amount of money which people would have for buying goods and services. When that quantity of money is in far excess of the quantity of goods and services, the general price level has to move up in order to facilitate the required volume of transactions. Hence, the magic solution for keeping inflation in check has been the production of money exactly in line with the production of goods and services in the economy. Any violation of this golden rule, for whatever the justifiable reason, would pave the way for the long run inflation to peep into the system. In this context, the Central Bank has an inalienable responsibility to take all the measures necessary to curb long term inflation.

The role of the Central Bank

The Central Bank takes monetary policy measures to keep the total volume of money in line with the total production and the volume of transactions in the economy. Money is being created by the banking system by using some sort of seed money called reserve money and produced by the Central Bank in its day to day operations. So all monetary policy measures adopted by the Central Bank take two different forms: at first, curtailing the production of its own reserve money and, then, checking the production of total money by banks.

But, the monetary policy is expected to operate by forcing the entire economy to cut down its excess demand for goods and services. This objective would be attained by making money more scarce and raising its costs to a higher level. Both these strategies would force the economy to make a very painful adjustment, by sacrificing the currently enjoying pleasures. This was eloquently described by a former President of US Federal Reserve, William McChesney Martin Jr., as withdrawing the punch bowl when the dancing gets going at its highest. Naturally, everyone on the dance floor would be disappointed by this seemingly cruel act, but the central bank does it for a good cause, just like a physician administering a bitter medicine to a dying patient to cure him.

The role of the banks and the private sector

So, the monetary policy measures taken by the Central Bank are all painful. It requires the economy to make a very painful adjustment, but that adjustment should be made for the benefit of every one. Those who are subject to this pain should have a good understanding of the virtues of this painful adjustment and be prepared to take the bitter medicine for a permanent cure of the ailment.

This casts a new responsibility on the banks, because monetary policy is implemented by the central bank through banks. In terms of this new responsibility, the banks should appreciate the intention of the central bank with a positive note. If the central bank raises interest rates and curtails credit levels, the banks should do much more than what the central bank has directed. It has to extend, both by deed and word, its full cooperation and commitment to attaining the monetary policy targets, because at the end, they are the main beneficiaries of having an inflation free world.

A similar responsibility is cast on the private sector as well. The Central Bank, like a good physician, has to flush out all the causes of inflation from the system. When doing so, it has to adopt painful and unpopular measures. But such measures are taken for the interest and the long term well-being of the economy. If the economy is allowed to be hit by inflation continuously, it is the private sector which would suffer most. It would be reduced from a long term planner to an at the moment event manager. It would be pestered with numerous requests for wage increases by the employees. Its profits would fall in real terms. Hence, it is the private sector which has to extend its utmost cooperation to the central bank to implement the monetary policy measures most effectively. This understanding at all levels of the private sector is a must.

The Government's contribution to inflation fighting

The governments are usually faulted for making the biggest contribution to inflation. The blame here is usually directed to the running of a high budget deficit by the government. This criticism against the government is not at all perfectly accurate. What contributes to inflation is not the existence of a budget deficit, but the financing of the deficit through inflationary means, viz, borrowing from the banking sector. Like the government's deficit, the private sector's deficits are equally contributory towards the raising of money supply and consequently to inflation. Hence, any blame should be squarely leveled against both sectors.

It is natural for any government to make use of the bank funding to fill budget deficits, because it is very convenient and cost effective. But, excessive use of bank funding leads to creation of additional money and through it, to inflation. Hence, governments have to behave responsibly. When inflation sets in as a result of its irresponsible fiscal policy, it is the government which has to suffer the most. The government's desire for bank financing has normally been equated to a child putting his fingers frequently into an open cookie jar. The duty of the central bank in such a situation has been to keep the lid of the jar tightly so that the child is unable to take out cookies at its own pleasure. This is not a popular measure, but central banks throughout the world have been found to keep the cookie jar in tight control for the benefit of the society.

Given the above economic costs, inflation is undoubtedly the public enemy number one.