

THE BASIC TRUTH ABOUT INFLATION

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I

CONTROLLING INFLATION IN INDIA

By

Prof. B. R. Shenoy*

If we may define inflation as an expansion of money which drives up commodity prices in general, inflation exists, incipient inflation apart, only when the General Prices Index rises. This index is both an indicator and measure of inflation.

The Union Ministry of Information, in an extensively broadcast pamphlet "India's war against Inflation", issued in January 1976, proclaimed that "ours is the only major country in the world" where inflation had "not only been checked" but had also "actually been reversed", i.e. we had rolled prices back, not merely restrained their further upsurge. This claim has been internationally quoted and was, reportedly, hailed and endorsed, among others, by Mr. H. J. Witteveen, the IMF Chief, and Mr. Robert S. McNamara, the World Bank President, during their visit to India last year; and, among our own business magnates, by Mr. J. R. D. Tata. Though recent pronouncements on the subject, by Government's spokesmen, have tended to be apologetic, the Congress Party's election manifesto, issued on February 8, 1977, is emphatic that we have "reversed inflation", while a "large number of countries are still struggling" with it.

While it may be quite pleasing to read this story of our global leadership in combating inflation, the price-harassed

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"Free Enterprise was born with man and
shall survive as long as man survives."

—A. D. Shroff

1899-1965

Founder-President

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house-holders have often wondered why this "success" has not been very much in evidence in their routine market rounds, apart from some short-lived halts or setbacks in the prices of certain consumer items.

To resolve this divergence between official claims and market observation, and also to devise ways of overcoming inflation, it may be helpful to review the origins, and the contemporary trend, of inflation in India.

To locate the origins of inflation, we may divide the economy into two parts, the government sector and the people's sector. Everybody knows that the incomes of the people, received in rupees, are but the rupee counterparts of their outputs; and that, in the final analysis, the people, cannot expend anything more than their earnings, expressed in rupees. As my output is picked up from the market by somebody else, against his rupee earnings, and, in like manner, I pick up someone else's output, it necessary follows that in the people's part of the economy, aggregate expenditures will always be matched by equivalent output. Hence, inflation and price instability cannot originate in the people's sector of the economy (though, having originated elsewhere, inflation may spread to the people's sector).

It is different with the government sector. Since independence, as in all inflation-ridden countries, Government's overall disbursements in India have exceeded the sum of taxes, loans and other receipts of Government, except for 1950-51 and 1951-52, when we had nominal budget surpluses. The excess disbursements were all covered by printing money or, which is the same thing, by creating Reserve Bank credit, the only ways of financing werall budget deficits.

When, in due course, a part of the moneys created to cover budget deficits—the primary expansion of money—reaches the banks and augment their cash holdings (reserves), the banks expand their credit—i.e. loans, overdrafts, advances and discounts—and a secondary expansion of money ensues.

As in under-developed countries generally, we have here the origins of infiation in India—budget deficits and the consequential secondary expansion of bank credit.

Primarily as a result of this double process—due allowance being made for other factors (which we need not now dwell on) affecting money supply—money supply in India multiplied 6.5 times, from Rs. 1,955 crores in 1954-55, when the current phase of inflation began, to Rs. 12,632 crores in 1975-76.

Not the whole of this colossal expansion of money (Rs. 10,727 crores) was, however, inflationary. During this period of monetary expansion, the Net National Product (NNP) more than doubled, from Rs. 10,483 crores in 1975-76 (at 1960-61 prices). This increase in NNP absorbed, roughly, a corresponding proportion of the expanding money supply. The rest of these moneys, the major part, to which no physical output corresponded, was inflationary, and drove prices up.

Thus, for inflation to emerge, what is material is an increase in money supply beyond the needs of the expanding output, not merely an expansion of money; so that, when inflation prevails, money supply, per physical unit of the national product, would increase. Under price stability, on the other hand, the ratio of money supply per physical unit of the national product, as during the early 1950s, would remain stable.

In 1954-55, money supply amounted to Rs. 1,955 crores and NNP, at 1960-61 prices, was Rs. 10,483 crores, i.e. one physical unit of NNP—valued at Rs. 10,000—was balanced by 1,865 units of money (Rupees). Money supply per unit of NNP being about stable in the preceding three years, we had comparative price stability, during this period.

But, from 1955-56 onwards, budget deficits and the comitant secondary expansions of credit, to which no physical output corresponded, continually drove up the ratio of money per unit of NNP; and prices continually moved up. This ratio doubled to Rs. 3,739, per physical unit of NNP,

by 1970-71, and the General Prices Index (1961-62=100) multiplied 2.47 times to 180.6; the ratio multiplied 3.10 times to Rs. 5,777 units of money, per unit of NNP, by 1975-76, and prices multiplied 3.86 times. It will be noted that prices accelerate faster than money supply. This reflects the tendency under price inflation to purchase and stock goods, rather than hold cash, as tomorrow's prices may well be higher than today's. As of 12 February 1977, when the General Prices Index had risen to 327.3, the pace of the price rise (relatively to 4 June 1955, the zero-date of the current phase of price inflation) averaged, per year, 16.5 per cent (simple) and 7.3 per cent (compound). The price rise continues.

A close look at the statistics of money supply and prices, during the past over two decades, conforms to the universal rule that the General Prices Index must move up, when the money supply per physical unit of the national product goes up. Aberrations from this rule are minor and temporary, and more or less cancel one another. The only violation of the rule is the continued price decline from an all-time peak of 330.7, touched on September 21, 1974, to a post-Emergency low of 282.3, touched on March 20, 1976, a fall of 14.6 per cent in 18 months. We shall examine this strange phenomenon later on.

Time was when it was fashionable to prescribe expansions of money as a solvent of unemployment, and to speed up economic growth. Experience has shown that inflation is capable of achieving neither, but may, on the other hand, produce "stagflation", i.e. economic stagnation and unemployment, on top of rising prices. There is no net gain whatever that inflation may yield. Its ravages include, on the special injustice front, perverse income transfers, from the indigent to already affluent minority—traders, businessmen and industrialists—through the erosion of wages and salaries, and through (the wholly unmerited) windfall profits, which inflation brings.

In terms of its value in 1954-55, every rupee of wages and salaries slid down to 40 paise by the close of 1970-71,

the **garibi-hatao** election year. Since then, the rupee depreciated further to 22 paise, i.e. mass poverty increased, instead of being abolished. The working classes lost, due allowance being made for any increase in their money wages since 1970-71, 45 per cent of their earnings, to stuff the overbulging pockets of the wealthy, the latter sharing this gain with Government.

The credibility of the claim of inflation-reversal apart, the promise of inflation control in the election manifesto of the ruling party is, therefore, most welcome. The reckless pre-poll concessions, increases in salaries and perquisites, and reductions in land revenues, however, conflict with this promise, as they may add to the inflationary budget deficits. Though other manifestos have not referred to this malady, we would like to hear that, if voted to power, other parties, too, would eschew inflation.

All this has revealed the unique phenomenon of a continued downtrend in the General Price Index for a period of 18 months—from September 21, 1974 to March 20, 1976—when money supply mounted higher and higher to fresh peaks in the wake of the unending printing press finance. During the two years, 1974-75 and 1975-76, which cover this price downtrend, money supply rose by 16.9 per cent, while the national product (NNP) went up only by 9 per cent. Though this involved an increase of 7.3 per cent in the money supply, per physical unit of NNP, strangely, the price index moved up (by 16.3 per cent) only during the first 4 months of 1974-75. Thereafter, defying all known monetary logic and empirical evidence, prices plummeted by 14.6 per cent.

Price reversals of this order should, through liquidations, impinge adversely on production and employment. Instead, during the two years ended 1975-76, industrial production rose by 15.3 per cent; and industrial employment expanded commensurately.

Government's claim that this price decline is part of the "gains" of the Emergency will not bear scrutiny. First, the

Emergency did not initiate the price decline. Prices had begun falling in September 1974. The Emergency came only 9 months later, on June 25, 1975. Secondly, following a down trend for another 9 months, prices turned upward, from March 1976, though in the meanwhile, the Emergency was intensified, through constitutional amendments. As of 12 February 1977, prices recovered by 15.9 per cent to 327.3, or well above their Emergency—day level (311-0). The Emergency, therefore, has not been capable of continuing the price decline. Prices took a course independent of the Emergency.

The resumption of the uptrend in prices demonstrates, too, the untenability of the poll-campaign assertion that the relaxation of the Emergency had led to a resurgence of inflation. This resurgence began in March 1976. The relaxation of the Emergency came only 10 and a half months later with the announcement, on January 1977, of fresh elections. Inflation is an act of the government, not of the people. its origins are in deficit budgets, not in the coming or going of the Emergency, and can be corrected only by non-inflationary budgetting. This calls for fiscal discipline on the part of Government, not the abolition of the civil liberties and fundamental rights of citizens.

The fall in the price index, as we shall presently see, was in the main, an artificially produced phenomenon.

In the wake of heavy budget deficits, prices had risen, in 1973-74, at a post-Independence record rate of 30.2 per cent, and rose in the first four months of 1974-75, at an annual rate of 35.4 per cent, which had been exceeded only in 1942-43. This called for drastic action. And in line with the official theory that price-inflation could be controlled through pressurised de-hoardings of stocks, a multi-pronged attack was launched against hoarding by traders and producers.

First, on top of the drastic overall credit restrictions of July 1974, selective credit control measures were severely

tightened, "sensitive commodities" receiving special attention. Secondly, police raids against stockists, hitherto only regional, became nation-wide, from October 1974. Thirdly, from about the same time, black money, which financed stock—piling, went deeper underground, with the arrest of smugglers, and the spread of income-tax raids to unearth unaccounted incomes and wealth. Forthly, from July 1974, the interest costs of inventories shot up. The maximum of the State Bank of India Advances rate rose from 9.5 per cent in 1973-74, to 13.5 per cent. in 1974-75, with similar increases in the Bank Hundi rate; and the Bazar Bill Rate moved up to 19.5 per cent (Calcutta).

With the declaration of the Emergency, the penal action against stockists, smugglers, and tax dodgers redoubled; and the interest rates further stiffened, the advances rate hiking to 14 per cent in 1975-76, the Hundi rate to 16.5 per cent and the Bazar Bill rate to 21 per cent (Calcutta) and 28 per cent (Madras).

Fifthly, Government imported, in 1975, 7.38 million tonnes of foodgrains, as against a market deficit of only 1.82 million tonnes; and in 1975-76, a similar quantity, despite a substantial market surplus of over 3.8 million tonnes.

In consequence of these measures, commodity stocks were unloaded on the market, from the close of September 1974, pushing their prices down. The heaviest beating was taken by the agricultural sector, the Cinderella of the Indian economy: in 18 months, foodgrains prices fell by 32 per cent and industrial raw materials by 31 per cent. The blitzkrieg did not apply to the industrial sector, viewed as a whole. The price index of industrial output—which accounts for 47 per cent of the national wholesale trade—rose nominally, from 272 to 274. The commodities, not amenable to stock-piling, fish, eggs and meat, remained unaffected, too. Their prices rose by 18 per cent.

In the past, the price effects of police raids, e.g. the "Operation Dehoarding" of June 1974, in U.P., had failed to last and were largely limited to the most affected

Mandis. The basic principle underlying this experience was simple. Panic sales of stocks do not add to overall supplies; nor reduce the monetary circulation. Such sale only shift stocks, from private to government godowns. A miniscule part may go into the neighbouring kitchen shelves. With overall supplies and the monetary circulation being unaffected, the price fall must remain local and only immediate. The basic rule does not change, whether the raids are local, regional or national.

Quite conceivably, the extended fall in the price index may be due, in addition to the pressures of the interest costs and of the withdrawal of black moneys, another factor which on closer scrutiny, may well turn out to be the prime explanation of this strange phenomenon. The 1975-76 **Annual Report** (p. 294) of the Ministry of Industry and Civil Supplies states that "since October 1974" its Civil Supplies Wing has functioned as the national apex body for both "bringing down prices" and—presumably, to assess the success of price-control action—for "monitoring the prices" of essential commodities. The machines turning out index numbers were, doubtless, fed only by the "monitored" prices, not by the market prices which house-holders pay—and, when price-control action and the assessment of its success is in the same hands, the two prices may not always be the same—the result of a natural bias for success. Index numbers, therefore, followed the course which "monitoring" took, not that of the monetary circulation.

Such things, and as unentionally, have happened in the past. Sir Jeremy Raisman, in his last budget speech (1945) presented "graphs" based on the Economic Adviser's index numbers to "prove" that "most of the usual indices responded encouragingly" to Government's "anti-inflationary measures". Raisman's index numbers rested on "controlled" prices. They bore little relationship to market prices. The latter merrily galloped ahead, reflecting the inflationary rupee finance of the British war effort. Eventually, however, the index numbers, too, indicated the course of inflation, their earlier fall being a self-created delusion.

Inflation is severely a monetary phenomena, not a law and order problem which MISA and DIR may render short work of. There is no device of bottling away inflationary moneys, not even in Soviet Russia. It is **most** unfortunate that the politicians in power and their economic advisers should ignore this basic truth and seek inflation control through other than fiscal measures. Obviously, the World Bank and IMF chiefs were misled by the index numbers, even like the Hon'ble Members of the Indian Legislative Assembly before them though when they visited India, the upturn in the index was well under way. They were taken in by what we may call the Raisman trick.

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II

40-YEAR INFLATION IN U.S.A.

by

Henry Hazlitt*

A casual reader of the newspapers and of our weekly periodicals might be excused for getting the impression that our American inflation is something that suddenly broke out in the last two or three years. Indeed, most of the editors of these periodicals seem themselves to have that impression. When told that our inflation has been going on for some forty years, their response is usually one of incredulity.

A large number of them do recognize that our inflation is at least nine or ten years old. They could hardly help doing

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so, because the official figures issued each month of wholesale and consumer prices are stated as a percentage of prices in 1967. Thus the consumer price index for June of 1976 was 170.1. That was 0.5 per cent higher than in the preceding month and 5.9 per cent higher than in June of the year before. This means that consumer prices were 70 per cent higher than in 1967, a **shocking** increase for a nine-year period. The annual increases in consumer prices ranged from 3.38 per cent between 1971 and 1972 to more than 11 per cent between 1973 and 1974. The overall tendency for the period was for an accelerating rate. The purchasing power of the dollar at the end of the period was equivalent to only about 57 cents compared with just nine years before.

But the inflation may be dated from as early as 1933. It was in March of that year the United States went off the gold standard. And it was in January of 1934 that the new irredeemable dollar was devalued to 59.06 per cent of the weight in gold into which it had previously been convertible. By 1934, the average of wholesale prices had increased 14 per cent over 1933; and by 1937, 31 per cent.

But consumer prices in 1933 were almost 25 per cent below those of 1929. Nearly everybody at the time wanted to see them restored toward that level. So it may be regarded as unfair to begin our inflationary count with that year. Yet even when we turn to a table beginning in 1940, we find that consumer prices as of 1976 are 314 per cent higher than then, and that the 1976 dollar has a purchasing power of only 24 cents compared with the 1940 dollar.

These results are presented herewith for each year in two tables. I am indebted to the American Institute for Economic Research at Great Barrington, Massachusetts for compiling the tables at my request.

The figures tell their own graphic story, but there are one or two details that deserve special notice. In the thirty-six-year period the nation's money stock has increased about thirteen times, yet consumer prices have increased only a little more than four times. Even in the last nine of those

years the money stock' increased 119 per cent and consumer prices only 74 per cent. This is not what the crude quantity theory of money would have predicted, but there are three broad explanations:

First, measuring the increase in the stock of money and credit is to some extent an arbitrary procedure. Some monetary economists prefer to measure it in terms of what is called M-1. This is the amount of currency outside the banks plus demand deposits of commercial banks. The tables measure the money stock in terms of M-2, which is the amount of currency outside the banks plus both the demand and time deposits of commercial banks. M-1, in other words, measures merely the more active media of purchase, while M-2 includes some of the less active. I have used it because most individuals and corporations who hold time deposits tend to think of them as ready cash when they are considering what purchases they can afford to make in the immediate or near future. But in recent years time deposits have grown at a much faster rate than demand deposits. So if one uses M-2 as one's measuring stick, one gets a much faster rate of increase in the monetary stock than by using M-1. (The latter has increased only eight times since 1949.)

Second, one very important reason why prices have not gone up as fast as the monetary stock is that both overall production and production per capita have risen steadily almost year by year. With the constant increase in capital investment — in the number, quality, and efficiency of machines — both overall productivity and productivity per worker have risen, which means that real costs of production have gone down.

The third explanation has to do with subjective reactions to increase in the money stock. Statistical comparisons in numerous countries and inflations have shown that, when an inflation is in its early stages, or has been comparatively mild, prices tend not to rise as fast as the money stock is increased. The fundamental reason is that most people regard the inflation as an accidental or unplanned occurrence not likely to be continued or repeated. When an inflation

is continued or accelerated, however, this opinion can change, and change suddenly and dramatically. The result is that prices start to rise much faster than the stock of money is increased.

The great danger today is that what has been happening from 1939 to 1976—to prices as compared with the rate of money issue—may have given a false sense of security to our official monetary managers as well as to most commentators in the press. The enormous increase in the American money stock over the past thirty-five to forty years must be regarded as a potential time bomb. It is too late for continued complacency. (Reproduced from "FREEMAN" of October 1976, with kind permission of its publishers granted by Leonard E. Read, President, Foundation for Economic Education, Irvington-on-Hudson, New York, 10533, U.S.A.).

The views expressed in this booklet are not necessarily the views of the Forum of Free Enterprise

TABLE A

YEAR	Money Stock (M2)	Consumer Price Index	Purchasing power of the Consumer Dollar
1967	100.0	100.0	100.0
1968	108.9	104.2	96.0
1969	116.2	109.8	91.1
1970	121.0	116.3	86.0
1971	135.0	121.2	82.5
1972	149.3	125.3	79.8
1973	163.6	133.1	75.1
1974	177.4	147.7	67.6
1975	191.0	161.2	62.0
1976	218.7e	173.9e	57.5e

Estimated from date through June.

TABLE B

YEAR	Money Stock (M2)	Consumer Price Index	Purchasing Power of the Consumer Dollar
1940	100.0	100.0	100.0
1941	113.2	105.1	95.1
1942	128.9	116.4	85.9
1943	162.9	123.6	80.9
1944	193.5	125.6	79.6
1945	229.4	128.5	77.8
1946	251.3	139.3	71.7
1947	264.5	159.4	62.7
1948	268.3	171.7	58.2
1949	267.2	170.1	58.8
1950	273.2	171.7	58.2
1951	283.3	185.5	53.9
1952	298.7	189.5	52.7
1953	310.1	191.0	52.4
1954	321.0	191.8	52.1
1955	332.8	191.2	52.3
1956	338.6	194.1	51.5
1957	347.5	200.8	49.8
1958	364.3	206.4	48.5
1959	381.3	207.6	48.2
1960	385.1	211.3	47.3
1961	405.3	213.5	46.8
1962	428.7	216.0	46.3
1963	456.4	218.6	45.7
1964	485.0	221.5	45.1
1965	523.9	225.2	44.4

TABLE B (contd.)

YEAR	Money Stock (M2)	Consumer Price Index	Purchasing Power of the Consumer Dollar
1966	564.6	231.8	43.1
1967	607.9	238.3	42.0
1968	662.2	248.4	40.3
1969	706.3	261.7	38.2
1970	735.4	277.3	36.1
1971	820.8	288.9	34.6
1972	907.4	298.6	33.5
1973	994.8	317.2	31.6
1974	1,078.5	352.5	28.5
1975	1,160.9	384.2	26.0
1976	1,329.2 ^e	414.3 ^e	24.1 ^e

^e Estimated from data through June.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good"

—Eugene Black

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