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Inflation

John Hyde

The Treasurer is saying remarkably little about Australia's inflation, which is almost the highest among OECD nations. High interest rates were once thought to be a cure for inflation, but ours are among the highest in the developed world, and so far they have cured nothing. He says the high interest rate policy is to fix the current account deficit, but so far it has not done that either. It is now apparent to everyone (including, surely, the Treasurer) that, at best, the policy is a long and painful one.

Although it may temporarily reduce inflation and the deficit by driving the economy into recession, the Government's economic strategy has substantially failed. Inevitably, people are looking for a better policy. The Treasurer should stop shooting the messengers. After all, most people once believed that his policies were better than they have turned out, and no-one sensible expects him to have had 20:20 economic vision. The policy failure does not, therefore, reflect too adversely upon him, but not admitting the failure in due course will.

Dr Peter Jonson, formerly Head of Research at the Reserve Bank, writing in *Policy*, has, like the present Deputy Governor of the Reserve Bank, drawn our attention to the unmentionable problem: inflation. A less-scared Treasurer would have welcomed comment from such a source. But instead he lashed out: accusing Jonson of being a principal architect of low interest rates in 1987 (following the stock market crash) and therefore of current inflation. Jonson, who is bound by public service secrecy provisions, cannot reply, but if he was soft on monetary policy, then he was a different Jonson from the one I have known.

Anyway, what Jonson said privately in 1987 matters less than what he is saying publicly now. Is he right when he offers the estimate that inflation is costing us one to two percentage points of economic growth? If he is, then in twenty years our living standards will be 21% to 46% lower than if we controlled inflation.

Jonson insists that inflation is theft. It allows governments and others to avoid paying their debts. Most

obviously, inflation steals from the 'widows and orphans' who purchase government bonds. Sophisticated investors, by contrast, buy inflation-proof assets, such as real estate, and incur inflation-affected liabilities such as cash loans. Of course, in time, interest rates rise to cover inflationary expectations.

It remains the fact, however, that in the complex world of an ever-changing unit of value, rewards go to those financial operators who can see through inflation's deception better than the next fellow. The moral implications of rewarding sleight-of-hand rather than production are serious---and who will say that there has not been a decline in the ethical standards of businesses and State Governments?

Because it is more profitable to finance smartly than to build a better house, make a better lawn mower or grow a better crop, that is where people's efforts go. Thus, inflation reduces productivity growth.

Inflation causes uncertainty, and uncertainty shortens time horizons. Not only are nominal rates of interest made high by inflation but so too are real rates. A currency with 2% inflation might have a nominal interest rate of 8% and a real rate of 6%; whereas a currency inflating at 8% might have a nominal rate of 18% and a real rate of 10%.

Inflation works against saving and investment. How often are we told to buy now to beat the price rise, or asked why we should save only to be taxed on the interest? Inflation raises domestic costs and prices relative to those overseas. These must ultimately be offset by devaluation, but devaluations are unpredictable and postponed by high interest rate policies. Who can plan in such an uncertain climate?

Jonson concedes that nobody knows the cost of inflation, but he suggests that it is a great deal more than the cost of the cure. The Treasurer, whose time horizon is likely to be the next Federal election, is apparently not so sure. After all, the cost may include his Prime Ministership.

Economists generally agree that inflation is caused by too much money chasing too few goods. Cutting inflation, therefore, involves cutting demand back to something less than productive capacity. That can be painful---people and plant are sometimes thrown out of work. Mr Keating has condemned 'fight inflation first' policies, but no one need be out of work if the surplus production is exported more nearly to balance the current account. Wasn't that what Mr Keating himself had in mind when he lectured us about putting resources into the traded goods sector?

The rub is that we cannot compete with other countries' traded goods, unless our costs are at least comparably low. But our costs, particularly our wages, are kept high by the fact that everybody expects Australian prices to go on inflating by 6 to 8% per year. Why wouldn't they expect continuing inflation? In each of 1960-61, 1974-75 and 1982-83

an inflationary spiral was checked by reducing demand. In the first case unemployment rose from 1.5% to 3% (a figure that nearly cost Menzies the election); in the second case from 2.5 to 6%; and in the third from about 6% to 10%. Hyper-inflation was avoided, it is true, but in each case, after the pain, the gains were thrown away---our inflation, relative to other countries, has got worse and worse.

To prevent inflation, people must be given reason to expect that the prices of the things they buy will stop rising, because only then will they stop raising the prices of the goods they sell. In the argot of economists, 'inflationary expectations' must be broken.

This, it seems, can only be done by taking the currency out of the hands of politicians---by tying it to several commodities (not just gold), by allowing better-managed currencies to compete with it, or by making the Reserve Bank independent of the Government and informing the Board it will be sacked if it does not perform. The last is how the Mark retains its value---and the Germans have not sacked a Bundesbank Board yet!

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