The aims of this paper are necessarily limited. The intention is to review bourgeois economists' interpretations of inflation and their prescriptions for controlling inflation, in an attempt to de-mystify the terms of current debates. Because the emphasis is on a review of bourgeois economic perspectives, there will be little discussion of the limits of bourgeois economic rationality as such — which fall outside the subject matter of the paper. However it is to be hoped that these limits will become obvious within the scope of the discussion. It is also hoped that it will become obvious that governmental manipulations of the economic system will not overcome the contradictions of capitalism — where the real problems lie.

In advanced capitalist economies the main emphasis of government policy is on the objectives of maintaining a high level of employment, a reasonable growth rate, reasonably stable prices and a comfortable balance of external payments. Inflation, in terms of price increases, affects the stability of these objectives in various ways and thus the government initiates various programs to regulate and control these price increases.

Large price increases in this century have been associated with war in that during these periods large increases in government expenditure, accompanied by large increases in the supply of money led to a general shortage of consumer goods and to a rise in their prices. From the market for consumption goods, the pressure spread to other markets. Unemployment diminished in the process as labor also became scarce. This was a situation call-
ed “galloping inflation.” However after 1953 most advanced capitalist economies became subject to “creeping inflation.” It was called “creeping” because price increases, although persistent, were much more modest than in previous periods of inflation and, for the first time, were not generated by abnormal forces of war or of post-war re-adjustments but were associated with normal forces of economic growth. Also after 1955 there was the unusual development (in terms of previous experience) of prices rising while unemployment was increasing and the supply of money was slowing down. For example it was noticed that after the onset of recession in mid-1957 in the U.K. prices continued to rise during 1957 and ’58, although employment fell. This situation which occurred in both the U.S. and Australia in the period 1970-72 came to be termed “stagflation” as the economy was stagnating but prices continued to rise.

Thus there arose a great deal of discussion amongst bourgeois economists about the causes of such inflation and the way to remedy it. A number of inflationary pressures were then identified which fell into two broad categories -- cost-push and demand-pull pressures.

(1) Those who believed that so long as prices were rising there were “excess demand pressures,” i.e., the demand for various goods is greater than the amount of goods available or the demand for labor is greater than that available, thus prices for goods and labor were forced up. Often those who identify this pressure deny that there can be any such thing as cost-push inflation on the ground that cost increases can be passed on to prices (the cost-push argument) only if aggregate demand (total demand for all goods and services) increases rapidly enough to absorb output at higher prices. Otherwise there will be downward pressure upon profit margins from excess supply and downward pressure on wages through growing unemployment.

(2) Increases in either export or import prices generate inflationary pressures in the domestic economy. Higher export prices are likely to cause increased demand as exporters seek to spend part of their higher incomes and this in turn may cause local prices to rise. Also local consumers may be forced to pay higher prices for “exportables,” i.e., goods which could be sold abroad at externally determined prices. Rising import prices enter directly into the costs of goods and services bought within the domestic economy and they also allow local producers to raise their prices without fearing a loss of sales to foreign suppliers. [1]

(3) Wage increases which occur at a greater rate than increases in productivity thus forcing up prices. This is the argument used by employers when opposing wage increases as will be stated in full. In situations of near full employment and with government committed to avoiding serious unemployment, unions would push fairly vigorously for higher wages. Wage increases would initially occur in high growth industries where labor productivity was increasing rapidly. Although this might not cause price increases, accumulative wage increases across a wide range of industries, in many of which growth of labor productivity was not high, would lead to price increases. Of course the price increases do not necessarily have to occur if the producer reduces his profit margin; however, for some reason this seems an untenable action.

(4) In opposition to the previous point there is the argument which says that prices are “administered,” i.e., fixed by sellers on a cost-plus basis. This is an important argument in a highly monopolistic and oligopolistic economy such as Australia. For example, price increases decided on by BHP generate increases in the prices of many other products as the users of steel and steel products find their costs increased. Thus the responsibility for price rises is placed wholly in the hands of oligopolists who increase their prices to maintain their profit margins.

It is also pointed out that there is a great deal of overlap and interaction between these four factors thus making it difficult to determine their relative importance in “explaining” inflation. However bourgeois economists have continued to argue and econometricians have continued to build and test models to determine whether inflation can in fact be attributed to cost-push or demand-pull effects -- without either of them coming to any definite conclusions.

Just as there is much disagreement about the causes of inflation, so there is a great deal of argument about the methods of controlling inflation and their effectiveness. The main way the government regulates the economy is by Keynesian measures. These operate by the government attempting to act on various components of aggregate economic activity to achieve the desired change. At this point it
would perhaps be useful to include a digression on the Keynesian model of the economy from which the policies employed by the government arise. In the Keynesian system aggregate economic activity (or national income) is made up of expenditures of consumption, investment, government and exports as well as a negative expenditure on imports (as the income derived from imports is not retained in the domestic economy but goes to the country from which the imports came). For these expenditures there are compensatory flows which counteract the income-creating effect of the expenditures. These flows are savings compensating for investment, taxation for government expenditure and imports for exports. To maintain a balance in the economy, under the Keynesian system, investment, government expenditure and exports must equal savings, taxation and imports. Increases in the former three are inflationary in that they add to total economic activity while increases in the latter three are deflationary in that they remove expenditure and thus income from the system. Thus in the Keynesian system the government will be concerned with bringing about the desired changes in these various expenditures to maintain a balance.

The two main policies employed by the government are fiscal policy and monetary policy. The main instruments of the government's fiscal policy are:

(1) Direct taxation which alters private disposable income (i.e., a consumer's income after taxation) and so private spending.

(2) Indirect taxation also affects real private income; to the extent that indirect taxes are "passed on" in higher prices, they reduce real private income as a whole and to the extent they are "absorbed," reduce profits (more unrealistic).

(3) Rates of transfer payments (i.e., pensions, unemployment benefits) can be regarded as negative direct taxes and thus have the opposite effects. If an increase of transfers is financed by higher direct taxes there are conflicting effects on private spending, but this is likely to show some increase if "those receiving the transfers have a higher propensity to spend than those paying the increased direct tax."

(Translated from the jargon this means that those who receive the transfer payments will tend to spend nearly all their incomes, as their incomes are small, while those who are paying the increased taxation belong to higher income groups and thus will tend to spend a smaller proportion of their income as part of their income is devoted to savings and capital accumulation.)

(4) Rates of subsidy payments have opposite effects upon private spending as do rates of indirect tax.

(5) Current government spending on goods and services is a component of aggregate demand and so affects this directly.

(6) Government capital formation, i.e., investment by the government, is also a component of aggregate demand. However insofar as investment, by increasing the stock of productive capital, makes for greater production in the future, it may be considered separately and more directly in relation to economic growth (in that investment decisions by the government are related to long-term objectives and thus should not be used for short-term fiscal adjustments). Some economists stress (mainly those in opposition to increased government intervention into the private economy) that government capital formation may be at the expense of private capital formation and that neither may lead to a proportional increase of productive capital and so of productivity. This argument ignores the necessity for government investment in so-called "unproductive" spheres such as education and health.

These are six instruments through which the government carries out its discretionary fiscal action. The government may foresee, but more often is made aware of, some malfunctioning of the economy and sooner or later takes compensatory action of a type and scale which they consider practicable [2], to correct it. However there are difficulties associated with timing such action. As a result of lags in applying corrective measures they could make things worse instead of better. One obvious case occurs if action to correct an upswing is so delayed as not to bite until a recession has already begun and so aggravates the downswing. This is what happened in Australia in the 1961 recession and also in 1971-72. Obviously a policy based on proper forecasts of the economic situation is likely to do better on this account than one which follows behind events.

There are other, more specific, difficulties associated with effective use of fiscal instruments. Firstly, current government spending on goods and services is largely connected with the protective and administrative functions of the state and should not (and cannot easily) therefore be subject to large or sudden
changes. Secondly public works (government capital formation) are more easily varied than current expenditures (although their flexibility should not be exaggerated). However in employing this instrument, a conflict arises between the objectives of stability and growth. When inflation develops, the rule employed is that public works should be cut down to offset it; however, this possibility is limited in terms of the problems which arise. These are mainly problems arising from public investment lagging behind private investment, through lags in provision of roads, housing, schools, etc. This is why recent stress on economic growth has tended to favor the idea that government capital formation should be geared to long-term needs for development, rather than being subject to sudden alterations in order to offset business cycles.

Thus emphasis has tended to shift to taxation as the most effective fiscal instrument for controlling aggregate demand. However, in practical terms, here again there are some difficulties, involved with political expediency. Whatever the political party in power, it is well aware that increases, especially in direct taxation, will prove unpopular. Thus it is likely they will be unwilling to increase taxation by the necessary amount for effective control of inflation. [3]

There are several other difficulties associated with fiscal action to control inflation which are related to the argument about whether the inflation is cost-push or demand-pull determined. These will be discussed more directly before turning to the question of an incomes policy. However, before doing this we will look at the operation of monetary policy and its weaknesses.

Monetary policy concerns the regulation of credit conditions by the government and the central bank (the Reserve Bank in Australia). The importance of monetary policy depends upon the extent to which credit conditions, in turn, influence private spending—an area of much debate. Before considering some of the issues of this debate it is necessary to look at the major types of monetary instruments.

(1) The discount rate. The central bank, by fixing the rate and terms for its own loans to commercial banks and other financial intermediaries, exerts an immediate influence on short-term rates of interest and also, perhaps, on business expectations. Discount rates remain of some importance in regulating international movements of short-term capital between financial centres, but its more direct influence upon domestic conditions has greatly decreased due to such things as the growth of self-finance by business. [4]

(2) Open market operations in government securities. This is a more important instrument in the US than in Australia because of the smallness and narrowness of the capital market. Despite recent attempts to widen the range of dealers in the capital market, the scope for open-market operations in Australia is still limited. Thus the main method has been:

(3) Variations of reserve requirements which fix the deposits which commercial banks are required to hold with the central bank. However, this tends to be used fairly infrequently and only to effect rather major changes in credit.

(4) Government control of the amount of money in circulation (liquidity) through the selling and buying of government bonds.

(5) A variety of direct controls such as controls over stock markets or real estate credit in order to check speculation, regulation of hire-purchase credit, etc. Such controls were important under war-time inflation and were retained by many countries for some years later, but they have such serious weaknesses (including those which concern political considerations for a capitalist government) that their use greatly declined as central banks were allowed [sic] to apply more general instruments.

The first of the difficulties faced by monetary instruments is that there is little evidence to show that interest changes have any influence on the majority of investment and consumption. This is especially so as far as investment is concerned, where it has been noted that, in relation to other costs and risks involved, interest changes are relatively unimportant.

The second major difficulty encountered is that of control over liquidity. The central bank has some control of the liquidity of the commercial banks, i.e., it is able to control the amount of money which the banks will have available for borrowing. However, in the post-war years there has been a remarkable growth of non-bank financial intermediaries (e.g., finance and insurance companies, building societies, merchant banks, etc.). The liquidity structure of these intermediaries is not subject to central bank control. This means that, for example, if in a period of inflation the central bank wishes to reduce liquidity, it will call up reserves from the commercial banks thus restricting the amount of money
available for borrowing. However, it is unable to do this with the non-bank financial intermediaries who will continue to extend credit in periods when the government wishes to restrict credit. Non-bank financial intermediaries are also not subject to interest rate control so can lend money at more favorable rates than commercial banks. This also reduces the effectiveness of monetary instruments, especially during inflationary periods.

However, the possibilities for the effectiveness of monetary policy are not totally pessimistic. As shown in 1971-72 in Australia, credit restrictions imposed by the government and central bank do have some effect on business confidence. However, as also shown, this tends to be a rather adverse effect as it tends to over-emphasise the deflationary effect and add to rather than improve the problem.

Thus monetary policy would seem to lack effectiveness especially in periods of inflation. Yet emphasis on fiscal policy also has its difficulties as we have already seen. There are, however, two conditions under which some economists claim fiscal action may achieve the double target of a high level of employment and stability of prices. One occurs if changes in prices depend on excess demand for goods; the other if prices depend on wages and money wages themselves on excess demand for labor. These are the postulates of the demand-pull argument as a cause of inflation. However, in the case of demand inflation, although fiscal policy could perhaps ensure stability of prices by preventing demand for goods from rising as high as to cause excess demand, there would necessarily be a fall in the level of employment to a level which would prove unacceptable.

Having seen the weaknesses of conventional Keynesian measures of control, attention was given to more direct controls through incomes and prices policies to supplement the traditional Keynesian measures. The problem was not that Keynesian measures were totally ineffective but, as has been pointed out, they had unacceptable by-products: increased unemployment, the interruption of economic growth and electoral reversals for the government concerned.

Incomes policy in the form of a pure wages policy assumes that inflation is cost-determined (a fact which makes it suspect from the beginning). There are two views as to how increases in incomes and productivity can maintain consonance. First of these views is that if negotiated or arbitrated wages can be geared to productivity, this will give sufficient control over total incomes to ensure close conformity with the productivity rule; for non-wage components of total incomes can be relied on to remain a stable proportion of the total (this, in reality, is not always true because a prices rise in the cost of various non-wage components will also increase them, e.g., industries using steel products).

The second view is that incomes policies should embrace both wage decisions and price decisions. Gearing wages to productivity ensures that labor costs are, on average, constant; but the maintenance of stable prices under these conditions cannot be left to chance. Even if non-wage incomes could be relied on to rise at no greater rate than wages, gaining acceptance of the policy by labor makes it necessary that these be no apparent "bias" against wage increases [sic].

To maintain some role for the price mechanism in allocating resources and regulating demand, advocates of incomes policies usually recommend the gearing of money wages to productivity and the maintenance of stable prices should be treated as average requirements and not as firm rules to be applied in every case. In particular the following modifications are often suggested:

(1) wages should rise by more than the average in industries needing to attract labor and by less in industries where labor is contracting.

(2) prices should be allowed to rise in industries with below-average rates of productivity growth and fall in industries with above-average increases in productivity. [5]

(3) movements of prices should be allowed to take account of changes in non-labor costs. However, even the bourgeois economists recognise weaknesses in an incomes policy. [6]

(1) It requires subordination of particular interests and goals to the public interest (of course, the interests of the workers). If a trade union representing a particular group of workers agrees to smaller wage increases than it could have obtained, it must expect its members' real wages to be less. This occurs because any check to inflation resulting from this restraint affects no more than a fraction of the goods and services which its members buy.

(2) The policy will cause significant redistributions of income. It is effective against wage increases but has little or no impact on increases in administered prices. Thus the
proportion of income going to wage-earners will decline.

(3) It is nearly impossible for those administering the policy to examine all wage and price behavior. Rather they must concentrate on "strategic" decisions in the hope that these will somehow influence the remainder.

(4) Attempts to interfere with wage increases may have adverse effects on industrial relations.

Thus it can be seen that the weaknesses of an incomes policy are such that it is the wage earner who would bear most of the adverse consequences of its application. This is amply shown by the British experience.

So, what about a prices policy? Bourgeois economists argue that selective price control (all that can be hoped for) will certainly have some moderating effect but only at the cost of causing dislocation in the particular industries to which it is applied. They say the uncertainty created in the private sector could well have adverse effects on the level of private investment which in turn would have longer-term effects on future output growth.

There are a number of points which can be made about this pessimistic prescription. Firstly, as noted earlier, it is difficult for those administering a prices policy to examine all price behavior. They will even have difficulty in concentrating on "strategic" decisions to increase prices as shown by the difficulties experienced by the Prices Justification Tribunal.

Secondly, the amount of dislocation caused by a prices policy is over-exaggerated. Overseas experience shows overwhelmingly that the very best which can be expected from combined controls on prices and incomes is a temporary respite during which more durable and more complex policies can be worked out. Thus the operation of a prices policy over a short period would not have the time to greatly change investment decisions and cause dislocation.

Thus it can be seen that, at best, prices and incomes policies are only short-term solutions in terms of purchasing some breathing space for other anti-inflationary action. However, it must be emphasised that, even in the short term, an incomes policy will lead to adverse effects on the wage-earner whereas a prices policy will lead to some moderation.

Inflation is something which seems endemic to advanced capitalist societies. Given that these economies are committed to the objective of economic growth (which can be seen in the pronouncements of the O.E.C.D.) inflation will continue. Bourgeois economists will agree that a moderate rate of inflation is necessary to achieve economic growth. However, it is obvious that both economic growth and inflation benefit only one section of the community -- the capitalists. Thus it is not surprising that the current methods of controlling inflation all exhibit weaknesses but have enough effectiveness to provide sufficient control to maintain the economic system as it exists.

NOTES

1. This is part of the recent argument that inflation is transmitted from outside the domestic economy. It is important to note in this argument the extent to which multinational corporations are responsible for the transmission of inflation through both their pricing policies and their international money transfers.

2. It should be noted that this practicality is, at times, not unrelated to political considerations rather than purely economic considerations.

3. A particularly good example of political considerations overriding economic considerations, although not related to taxation, occurred in Australia early this year. Following the government's move to reduce liquidity by increasing interest rates on borrowing, Caucus, fearing unfavorable reactions from their constituents, demanded preferential interest rates for some home-owners and home-buyers. This action, especially occurring in the most over-inflated sector of the economy has, as one commentator pointed out, "impaired the functioning of an important element of the Government's economic policy." (Alan Wood, "Hot Politics Threaten G. Whitlam's Cool Economics," National Times, Sept. 24-29, 1973.)

4. This growth of self-financing by companies can be associated with the growth of the multinational corporation and has led to the decline of the power of finance capital as opposed to industrial capital.

5. It never ceases to amaze me that bourgeois economists seriously include in their models and prescriptions, provision for decreases in prices. They are aware, surely, that prices are extremely "inflexible in a downward direction" (to use the jargon) and yet they never fail to pay a great deal of attention to the possibility of a price decrease.

6. In fact, one would almost begin to wonder why they bother to advocate it in the first place -- if the answer were not so obvious.