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DISCUSSION PAPER

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Inflation: A Sketch for a Theory of World Inflation

by Dudley Seers

DP 169 November 1981

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In Discussion Paper 168 a framework for analysing inflation was derived from Latin America. This frame is used here as a classified checklist for the world as a whole. First I look at the industrial countries: these provide base levels of inflation for the world economy, and they too are now suffering from chronic adjustment strains. The same is true of the world viewed as an economic unit, although the expansion of international liquidity - the analogue of national money supply - is also important. Finally, I look at world inflation in historical perspective. The price stability which lasted for a century up to 1914 depended basically on the absence of supply constraints and on the strength of one hegemonic power, Britain. There is now no plausible candidate for this role. Prospective shortages of oil and food, together with growing structural strains, suggest that attempts to impose strict monetary discipline on the world economy would prove, as in Latin America, socially damaging and ultimately self-defeating. However, what is really at issue is the future of the neo-colonial system.

Inflation: A Sketch for a Theory of World Inflation*

INTRODUCTION

Inflation is a world problem. In the last few years the world average rise in consumer prices has been over 10 per cent; in 1979-80 it was 16 per cent - see Table 1 below.[1] A rate of inflation of over 10 per cent is found now in nearly all countries, including some that have not previously known price increases of more than a few per cent a year in peacetime.

Table 1 Index of consumer prices: the world, 1952-1980 (1975 = 100)

Year	Index
1952	33
1957	37
1962	43
1967	54
1972	70
1973	77
1974	88
1975	100
1976	111
1977	124
1978	135
1979	152 p
1980	176 p

p preliminary

Source: International Financial Statistics, International Monetary Fund.

The index is a geometric mean of national consumer price indices (112 in number for recent years) weighted by gross domestic products expressed in US dollars. Socialist countries are not covered. See 'Measures of Global Inflation', Global Division, IMF, August 1979

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* The prelude to this paper is 'Inflation: The Latin American Experience', Discussion Paper 168, IDS, Sussex, 1981. These two papers will be published together by the University of Notre Dame, either as a monograph or in a symposium on inflation. They are based on lectures I gave at Notre Dame earlier this year. I benefited very much from the discussions that followed the lectures, and also from comments by Ed Clay, Carlos Filgueira, Stephany Griffith-Jones and Hans Singer. Numerous lengthy and perceptive comments from Manfred Bienefeld were especially useful.

It is also a world problem in another sense. Certain of the influences on prices can only be studied as global phenomena: not merely oil, but also the growth of the Euromoney market, for example. Analysis of inflation in a single nation, however big its economy, can therefore only be partial.

Many would say that in order to explain world inflation we do not need any elaborate global analysis: the culprit is OPEC, which engineered the ten-fold increase in the dollar price of oil in the eight years since the Yom Kippur war at the end of 1973. But world inflation did not begin in 1973. After virtual stability in the middle of the 1950s, price rises were already starting to accelerate persistently in the 1960s, although oil prices were very low and indeed falling. In 1971 and again in 1972, the average rate of world inflation on the IMF measure was six per cent, and in most individual countries it was faster than in the 1960s. It is true that oil prices were already starting to move upwards then, but not by nearly enough to cause such a big general price rise. In the first half of 1973 this reached eight per cent (at an annual rate). By then world consumer prices were already, on average, more than double what they had been two decades earlier. Moreover, prices of traded goods other than oil were rising rapidly, making it certain that world inflation would continue to accelerate in 1974. Oil has of course played an important part, but we have to look much further afield.

Two points should be made at the outset. First, it is not necessary for my present purpose, sketching a theory of world inflation, to make a detailed and comprehensive analysis on each plane. In order to cover this mammoth subject within the space allotted, in places I rely on generalisations that are not fully documented or adequately qualified.

Secondly, various government expenditures, eg social benefits, will be described as inflationary. There is no implication that these are simply on that account undesirable. They would be if inflation were the supreme economic evil, but this raises personal value judgements. Surely inflation is not intrinsically an evil at all: its undesirability is instrumental - lying in the extent to which it causes true social evils, such as undernourishment and ill-health, and those who advocate a particular counter-inflationary policy will need to show that its social damage would be less.

Moreover, migration controls, import quotas, etc will be depicted as among the obstacles to world structural change. Here again there is no implication that for this reason any particular government should forego them: in the absence of an international authority for redistributing income, each government has to secure what it perceives as its own national objectives as best it can. Similarly, the fact that fast population growth and big military expenditures aggravate world inflation is in itself no argument for any particular government checking them - though their internal effects,

which include stimulating inflation, may well be best avoided.

I Causes of World Inflation

The discussion of Latin American inflation in Discussion Paper 168 led to an explanation which can be briefly summarised as follows. Although structural change has been imperative it has been impeded, and the resultant price rises have been generalised by propagation mechanisms, including increases in the supply of money.

The main factors mentioned above can thus be grouped as follows:[3]

Pressures for structural change

- fast population increases;
- politically imperative requirements for social development;
- slow growth of food output;
- increasing dependence on imported oil;
- increasing dependence on imports of advanced industrial products.

Obstacles to structural change

- imperfections in labour markets;
- imperfections in capital markets;
- inadequate transportation;
- use of taxes for unproductive expenditures;
- bureaucratic regulations.

Mechanisms that can propagate inflation

- trade unions, professional associations, landlords, etc acting to protect real incomes;
- monopolies (or oligopolies) in production and services;
- monetary authorities that accommodate price rises.

And behind all these lies the question whether the government has sufficient understanding, power and commitment to carry out structural change, involving heavy basic investments and also to enforce monetary discipline, ultimately a matter of the balance of political forces.

To examine every country to see whether this framework of analysis suited them would be a mammoth task.[4] However, it is worthwhile pausing to ask whether the approach has any application to inflation in the industrial economies. In the first place, the weight of these countries in the world

economy is considerable. Secondly, the price rise in a leading industrial country provides a base rate of inflation which can hardly be avoided by its trading partners (especially those with output consisting mainly of 'tradeable' goods and services).[5] Thirdly, the monetary policies of their governments, as we shall see, affect considerably the liquidity of the world economy. Fourthly, this approach may bypass the heated but sterile debates between monetarists and Keynesians.[6] However, since even this group of countries is very diverse I shall confine my illustrations to three of its leading members - the United States, Britain and Japan (price data for which are given in Table 2 below).[7]

Table 2 Index of consumer prices: industrial countries, the USA, UK and Japan, 1952 to 1980 (1975 = 100)

	All industrial countries	USA	UK	Japan
1952	42	49	31	27
1957	45	52	35	32
1962	51	56	39	37
1967	58	62	46	49
1972	74	78	64	64
1973	79	83	69	72
1974	90	92	81	89
1975	100	100	100	100
1976	108	106	117	109
1977	117	113	135	118
1978	126	121	146	123
1979	137	135	166	127
1980	154	153	196	137

Source: same as Table 1

Some of the factors listed clearly have much less relevance to this group of countries. Population growth has been much slower in recent decades and food output has generally been at least keeping pace with domestic demand. Others are, however, applicable to some degree, although they take a different form in an industrial economy. While there is not the same moral and political imperative to eliminate widespread poverty, the need to reduce unemployment plays a similar role. So does the insatiable thirst for more public services, especially health and education, requiring continued expansion of the national income. Moreover the titivation of consumer greed by the media stimulates not merely the growth of consumption, but, as incomes rise, changes in its composition.

Most countries in this group have become heavily dependent on imported oil, which exposed them to the 'oil shocks'. This meant, for them too, foreign exchange bottlenecks and

pressures on the exchange rate, and required the development of local sources of energy (eg coal, nuclear power), shifts towards less energy-intensive goods and services, and increased conservation. It also intensified the battle for world markets in manufactures.

As in Latin America, there has been a growing tendency to import industrial products, but with different implications: in Latin America the imports are increasingly of producer goods and create structural dependence. In the big industrial countries consumer goods industries such as those making automobiles, television sets, etc have been threatened by imports, from Japan in particular, but also from TNC subsidiaries in the NICs. Still the consequences are similar, structural change has become necessary in industrial countries too, to make the penetrated industries more competitive, or to create new sources of employment for those displaced from them. At the same time, technological advances based on the 'chip', such as word processors and the use of robots, which have hardly reached Latin America yet, have also started to displace labour on an increasing scale.

The pattern of obstacles to the necessary structural shifts has also reflected those in Latin America, partially and with due modification - with due allowance for differences among industrial economies.

Inadequacies in capital markets and transportation systems are less serious than in Latin America; although bureaucratic regulation is far from negligible, it has greater inherent rationale and involves less delay or corruption. On the other hand, movement of labour to expanding industries has often been inhibited in thse countries too, especially in Britain, but by different obstacles - rent controls, subsidised public housing, corporate pension schemes, job tenure, 'featherbedding' and unemployment benefits that have become virtually unconditional and yield incomes which are not much below current wage levels.

Moreover, as in Latin America, money that would have otherwise financed investment in industry or new sources of energy, etc, has been diverted to unproductive ends by taxation (or government borrowing), whereas very high interest rates make basic investments unprofitable. In addition, much of the capital in the industrial countries has been exported to the NICs.

It is worth recalling the familiar point that while arms expenditure, which is heavy in Britain and the United States, increases purchasing power, as investment does, it does not, in contrast to investment, create capacity that would in due course augment the supply of goods and services and relieve shortages. Moreover, much expenditure on arms not only diverts finance from making economies more flexible: it also increases the need for this flexibility, because it draws professional and skilled labour, energy, etc from other

sectors. (Missile and anti-missile systems are both highly skill-intensive.)

A similar point can be made about the expansion of government services in the industrial countries (again, especially in Britain and the United States). Indeed, this is perhaps more significant an influence on inflation than in Latin America, where it is not merely relatively smaller: since output is constrained there by ill-health and illiteracy, health and educational outlays have a much more direct impact on productive capacity. In particular, education and training are essential in Latin America for the shift of labour into secondary industry. In the industrial countries by contrast a large part of educational spending is at tertiary level, where education is undertaken largely as a form of consumption, treated as a civil right and not necessarily vocational.

The propagation of inflation must be powerful in the industrial countries too, with Japan again a partial exception; otherwise the effects of impulses such as each of the oil shocks would have died away sooner. The main reasons seem to be, perhaps more than in Latin America, the strength of industrial and financial corporations, and also of organisations to protect incomes, such as those of workers and farmers. Here too there is extensive indexation, either formally or in the sense that general price rises are treated as a yardstick in negotiations about wages, etc.[8] Trade unions in key sectors (such as coal) cannot be gainsaid and the rises they achieve reinforce the demands of others.

In many of these respects, the Japanese economy has become more flexible than that of the United States (and much more flexible than the British) despite heavy dependence on imports of oil and foodstuffs. This flexibility is shown by the relatively mild effect of the 'oil shocks' there, especially the second one.

Finally, although the governments of the leading industrial countries have a much more authentic basis for political power than those in Latin America, they too have failed to tackle structural change effectively, eg energy development and conservation. Indeed, partly to try to break the mechanism of propagation, they have usually tried to suppress the effects of rising oil prices on the prices of petroleum products, thus discouraging conservation and the development of new energy sources. They have also permitted, especially up to 1979, a fast enough increase in the money supply to accommodate price rises. I shall return to this point later because their conduct in this policy area has been a major factor in the propagation of worldinflation.

Let me now discuss the applicability of the above list of influences on the world plane.

While the world's population has not increased quite as

rapidly as that of Latin America, the rate has been 1.8 per cent in the 1970s. So the imperative of development has also applied to the world as a whole. Moreover, political pressures to solve social problems, including unemployment and under-employment of various kinds, have become powerful everywhere. Related to this is a growing demand, spelled out (if vaguely) in the New International Economic Order, to change the distribution of world income, stimulated by the great and growing contrasts, between (say) on the one hand Frankfurt, Tokyo or New York, and on the other Calcutta, Accra or La Paz, contrasts of which people in the latter cities are increasingly aware. And what appears to those in the industrial countries as threatening forms of import penetration are, from a broader viewpoint, necessary changes in the structure of the world economy.

To assess whether there has been a 'food' bottleneck on the world scale is not straightforward - even if we confine our attention to the _effective_ demand for food. Production has kept just ahead of the population increase, allowing a total rise of nearly one per cent a year in _per capita_ output in the 1970s.[9] This was barely adequate to satisfy the rise in _per capita_ income, even though that had slowed to 2½-3 per cent a year.

Besides, these global averages are not very helpful. The increase was fastest in the United States, Canada and Australia, where consumption levels were already the highest in the world and demand was growing slowly.[10] Moreover, the spurt in output was partly at the expense of bringing back into use land which had been kept out of production by the US Department of Agriculture. Elsewhere, because of constraints on food output, the expansion of arable land has become slow and world inventories of foodstuffs, including cereals, have fallen to precariously low levels. US dollar prices of food in international trade soared in 1973 (before the oil crisis) and though there was then a fallback, it was to much higher levels than previously: taking 1970 to 1979 as a whole they rose 2.7 times - faster than US prices in general, which roughly doubled.[11]

The energy constraint for the world as a whole has been more effective and more inescapable than for any particular nation. Governments could evade it - if the foreign exchange was available - by importing oil. The transnational 'modern' culture, which is highly energy-intensive (cars, central heating, air conditioning, refrigerators, etc) and its associated energy-intensive production technologies have been sweeping across the world. At first, this raised no supply problems: even the doubling of world oil consumption in the 1950s, and again in the 1960s, was offset by new finds in the Middle East and elsewhere. The world price of oil fell from $4 a barrel in 1950 to under $2 in 1970. But the net additions to proven world oil reserves declined to low levels in the mid-1960s and then the estimated oil in new discoveries

each year began to be exceeded by consumption.[12]

During the early 1970s oil consumption continued to boom in both industrial and non-industrial countries because of the pattern of development briefly described above. Oil prices began to recover and the stage was set for them to start soaring at the end of 1973, on the outbreak of hostilities between Egypt and Israel. However, this seems merely to have anticipated what would have occurred before long anyway, because of the pressure of demand, though perhaps less sharply. One of its results was paradoxical: some oil exporting governments in the Gulf, such as the Kuwaiti, have apparently a backward sloping curve, and the high price level itself caused them to reduce production, aggravating the basic market imbalance (quite apart from the effects of the Iranian Revolution and the Iraq-Iran war).

The world economy is far from flexible enough to cope with such strains. Linguistic and other cultural barriers are much stronger discouragements to the movement of labour across national frontiers than inside them. It is true that the heavy migration of Mediterranean labour to Continental Western Europe from about 1960 to 1972, and of Caribbean labour to Britain and the United States (which also drew in Mexican workers), helped provide the manpower for the vigorous expansion of that period, especially in jobs, such as hotel work, which were unattractive to local labour. But this is not at all a worldwide phenomenon. For example, cultural homogeneity in Japan is apparently too strong to permit immigration (except for a trickle from Korea), despite the rapid growth in the need for labour. Moreover, such migration has always been controlled and the controls were tightened from 1972 on - before the oil crisis - by the governments of the recipient countries: labour needs, especially for unskilled workers, were increasingly met by higher wages to domestic labour or by more intensive capital investment, raising costs. A new pattern of labour flows started towards the oil-exporting countries of the Middle East, though the source was first largely Egypt and other Arab countries, and later Asia (especially South Korea).

Private capital for direct investment moves more readily between industrial economies, especially through the TNCs, but towards the rest of the world it has been inhibited, especially in oil and other minerals, by 'lack of confidence' due to the fear of expropriation or at least heavier taxation and controls on remittances of profits.[13] Although commercial bank loans have increased dramatically, this has mostly been to a dozen or so 'creditworthy' economies with apparently stable governments and docile labour forces, such as Brazil and South Korea.[14] Certainly bilateral aid is spread more widely, but it is no longer increasing and is largely tied to the purchase of products from donor countries.

The scale of the world's non-productive expenditures, especially on arms, seems quite inappropriate in relation to

the social imperatives in the world as a whole. While individual governments can claim that their level of military expenditure can be afforded without severe social costs, and perhaps that it is inescapable because of external threats, neither of these arguments are valid on the world plane (there is little danger, except in science fiction, of invasion from other worlds).

Looked at from a world viewpoint there cannot be any general foreign exchange shortage. However, the lack of currency convertibility not merely reflects, it also aggravates, structural problems. Thus the increment in world food production has gone in large part to raising the already high consumption in the industrial capitalist economies and to meeting the now chronic import needs of the Soviet Union and Eastern Europe. Imbalances appeared in many countries. Similarly, foreign exchange shortages inhibited the movement of oil and advanced industrial products, including capital equipment needed for investment in agriculture, oil and other basic sectors.

On the world scale, transportation costs have become more serious obstacles to movements of goods, especially heavy cargoes, since the price of oil soared, although this has been temporarily mitigated by surplus capacity in ships and aircraft.

There are also other barriers to movement which are not found within national economies. Tariffs and non-tariff barriers are too well known to emphasize here. The point is that they naturally reflect national interests in particular objectives such as checking the rise in unemployment, rather than optimal resource allocation. Such barriers to trade have increased in recent years, notably through the textile quotas imposed under the Multi-Fibre Arrangement, and autarchic agricultural policies in the European Community. Very few of the growing arms contracts of the major governments are put out to open universal tender, although this would ease the shortages, especially of technical skills, these create.

The growth of TNCs must have increased world market imperfections. In many industries they prevent subsidiaries or licensees buying equipment or inputs freely or selling in certain foreign markets.[15] They also form large nodes of quasi-monopolistic power that propagate inflationary impulses - the leading oil companies, for example. Cartels (such as the International Air Transport Association) have had a similar effect, as have some commodity agreements.

Another power group we have mentioned already in connection with Latin America has its counterpart on the world scale - international trade union federations. These try, _inter alia_, to raise wage levels in countries where these are particularly low, reducing competition with the working classes in the rich industrial countries.

There were therefore structural reasons for world inflation, and many propagating factors. However, inflation would not have picked up such speed and momentum but for monetary expansion. Here we have to go back to the 1960s - to the simultaneous US entry into the Vietnam war and the expansion of the welfare state (the 'Great Society') without corresponding increases in taxes. This combination of policies not only unleashed inflationary pressures in the United States itself (mild by later standards): it led to a fast decline in gold reserves and an outflow of dollars.[16] Since the latter were treated as prime assets by foreign Central Banks, the result was a sharp rise in international reserves, a doubling, in fact, from 1969 to 1972.[17]

The Euromoney market which had come into being in the late 1950s (mainly because of controls on interest rates in the United States and limits on branch banking) absorbed the bulk of this dollar outflow. Here credit could be created outside the control of any national government, and lent all over the world, often causing increases in reserves difficult for Central Banks (in Latin America as elsewhere) to sterilise. The consequences for the world economy were analogous to those of monetary expansion in a national economy. The worldwide propagation of inflation was facilitated, and it could pick up spped.[18] (See Table 1.)

The strain on the dollar led first to the abandonment of its external convertibility into gold, the world price of which started to climb, and then to the reorganisation (in 1971) and finally the collapse (early in 1973) of the whole system of fixed exchange rates set up at Bretton Woods. Governments faced with a foreign exchange crisis could now let currencies decline, as an alternative to imposing deflationary policies.

It is important to note, as I said at the beginning, that the Bretton Woods system collapsed <u>before</u> the cutting back of oil supplies at the end of 1973 and the sharp rise in oil prices. However, the oil shock naturally gave a further impetus to world inflation. Moreover, the big payments deficits in the oil-importing countries could be covered by borrowing their counterparts, the OPEC surpluses: so the rise in the price of oil provided the money to enable this same rise to be financed in the Euromoney market. (The price rise could hardly have been so great in a more tightly managed world monetary system, although it is very doubtful whether even the gold standard in its heyday could have survived shocks of this magnitude.)

As the balance of the world market in oil improved, its real price declined somewhat from 1975 to 1978, but although the pace of world inflation abated slightly (see Table 1), the propagation mechanisms were too strong to permit general price declines. Indeed, inflation accelerated once more in 1979 when Iranian oil output fell by some five million barrels a day, following the revolution there at the end of the previous year. It was

again facilitated by the same mechanism of expanding international liquidity.

So on the world plane too, both structural and monetary influences have to be taken into account, but, as in the case of Latin America, analysis must focus on political forces that prevent the solution of structural problems and compel monetary expansion. The interaction of economic and political developments will be examined in the next section.

II World Inflation in Historical Perspective

There was little net change in world prices over a whole century, from the Battle of Waterloo in 1815 to the start of the first World War in 1914. Although prices did sometimes rise during that period, they also at times declined.

It is widely believed that this long period of overall stability was due to the operation of the gold standard under the Bank of England's management. But a strict monetary regime was hardly needed. During this century population growth was slow; nationalist economic aspirations were weak; considerable areas of new land became available for cultivation; communications improved; supplies of coal, the prime fuel for expanding economies, were plentiful. There were vast movements of labour, first as slaves then under indenture arrangements, to man the plantations and mines. It is true that colonial rule secured for metropolitan firms the trade of the colonies and preferential access to their investment possibilities, but by comparison with the situation today, there were far fewer institutional obstacles to the movement of goods or capital: there was a prolonged and fast rise in trade in food and raw materials.

It was the colonial system that was really responsible for the absence of a price trend. The gold standard was nonetheless an important element in this system. Capital could flow out, confident that returns on it would be remitted homewards without any difficulty and that it could be repatriated at will. International liquidity was limited by the volume of gold output.

The gold standard needed a management that was not only hegemonic but also financially prudent. British governments were not, however, during this century, under irresistible internal pressure to adopt an expansionist monetary policy. The colonial system remained sufficiently profitable to permit not only rising outlays on arms, but also increases in domestic wages, as trade unions became more powerful, and increases in social expenditures in response to the extension of the suffrage.

But an even more essential element was a political authority with sufficient strength, in the last resort military power,

to permit settlement of new lands and access to mines, and to ensure that the rules of the game were respected. The Royal Navy rather than the Bank of England preserved price stability.[19]

The gold standard was imposed on the colonies: even where, as became increasingly frequent, a local currency was issued, this was fully backed by that of the metropolis, and therefore was similarly related to gold. The governments of the United States, the smaller countries of Western Europe and Latin America found the standard convenient: indeed if they were to participate in the expansion of international trade they had little option but to keep their own currencies convertible.[20] At that time the alternative, exchange control, was hardly imaginable: financial unorthodoxy was punished by economic, at times even military, action.

As the decades passed, British hegemony was gradually undermined by the rise of what can be called 'newly industrialising countries', especially Germany, which had the incentive and increasingly the power to challenge it, and did so in 1914. The war brought imperatives in some respects analogous to those of 'development': some types of output had to be rapidly increased. At the same time it destroyed the worldwide trading system on which price stability ultimately depended. In Britain, where chronic needs had been created, under the colonial system, for imported food and industrial materials, few resources could be spared for exports to buy them.

It is true that the government could borrow heavily in the United States, but naturally it became unwilling to take on a bigger war debt than was absolutely necessary, and in any case imports were inhibited by the U-boats. Inflation could be temporarily suppressed by wartime controls on wages, but it burnt out soon after the war ended, until it was damped down by the restoration of supplies.

However, the significance of the change in the world power structure was not generally understood. In the 1920s the pre-war monetary system was reassembled, but precariously, and, in retrospect, unfortunately. It was especially unfortunate for Britain itself, where an attempt was made to restore sterling as a convertible currency at the pre-war exchange rate. The demands of the unions, which had been stimulated in the colonial period, were now much more difficult to meet and a period of social confrontation opened, which was signalled by the General Strike of 1926, and still prevails more than half a century later. In the other industrial countries the restoration at first appeared successful: industrial expansion was rapid until the world depression started to gather momentum at the very end of the decade.

But a government could then only stay 'on gold' by adopting deflationary policies. These not merely caused high levels of

unemployment but also aggravated the problems of trading partners. The political cost of convertibility into gold became too high for one government after another; the gold standard was virtually ended by 1932, and protection increased. Some revival in output then took place and world prices started to rise (though it is difficult to assess how much this was due to war preparations, which were getting under way, especially in Germany).

The second world war caused an even bigger disruption of the world supply system than the first.[21] The raw material suppliers accumulated unspendable currencies, especially sterling. By its end, the hegemony of Britain was finally broken; its industries had been damaged by bombing and their re-equipment was long overdue. Powerful forces of nationalism had been unleashed, especially in Asian colonies taken over or threatened by the Japanese. Inventories had been run down, and heavy dollar debts were incurred. For the colonies independence started to become a political reality and later, in some degree, an economic reality too. Yet precisely at this time an attempt was made to convert Britain into a 'welfare state'.

There was now only one candidate for the hegemonic role - the United States. Having been spared physical damage on its own territory during the war, it alone could take full advantage of technological advances; considerable gold reserves had been built up; its military power and political predominance were overwhelming. The dollar could thus serve as a unit of account and settlement, almost equivalent (as sterling had been) to gold when held by the central banks of other countries. Under the Bretton Woods agreement a system of convertible currencies was linked by fixed exchange rates to the dollar. This was similar to the gold standard, though (memories of the World Depression being still fresh) with greater flexibility: an International Monetary Fund was set up in order to enable governments to meet short-period payment problems without retrenchment.

However, we must avoid the trap of looking at the new transnational economic system as essentially a monetary phenomenon. The Bretton Woods settlement provided, as the gold standard had done, merely one element in a system which can be called, not inaccurately, neo-colonial. Some of the main features of the colonial system were recreated, in particular the flow of private capital to the 'Third World', which still provided much of the primary produce needed by the industrial countries.

This system worked quite successfully for a while, from the viewpoint of its creators. It was able to withstand the disruption to commodity markets during the Korean War. But it depended on the hegemony of the United States and, just as had happened to Britain earlier, the basis of this, its technological lead, was gradually eroded. Productivity

increased more rapidly elsewhere in the capitalist world, notably in Japan and West Germany. Moreover, US policies in the 1960s, outlined above, showed clearly that there was insufficient political backing for the total set of economic policies to be shaped in a way that would ensure the viability of the Bretton Woods settlement. The failure to achieve victory in the Vietnam war not merely carried military implications: it signalled (as the Bay of Pigs had done earlier) inability to impose solutions on the periphery.

In the 1970s, the system disintegrated further with the collapse of the structure of fixed exchange rates mentioned above and the oil shocks. The price of gold soared and world monetary reserves grew ten-fold in one decade.[22]

This disintegration is often interpreted as having started in the 1970s, due to the abandonment of the Bretton Wood regime. But on the above analysis, it was fundamentally attributable rather to the structural strains which had been growing for some time - and the inability of the hegemonic power, the United States, to contain them (just as earlier Britain had failed to preserve the colonial system and its gold standard). The collapse of the Bretton Woods system was a symptom, not a cause.

Something still remains, anyway - the IMF, in which the United States and other leading industrial countries exercise effective control. However, its function has drastically changed. Instead of being the means of avoiding the spread of recessions, it has taken over part of the disciplinary role once played by the Bank of England, under the gold standard. While it can provide some finance to ease payment problems, due for example to the oil price rise, the 'conditionality' on these drawings requires governments to take measures which in effect slow down rather than maintain their economic growth and spread a recession, rather than contain it. The Fund's behaviour shows that its first priority now is to see that countries remain fully integrated into the neo-colonial system, with convertible currencies. But it has relatively small resources - no direct military power - and can only exert much leverage on those members in severe foreign exchange difficulties: this means it has little influence on the governments of many industrial countries or on those that export oil. The coherence of its policies is further weakened by disagreements between the Executive Directors appointed by the governments of the leading industrial countries, and it has more recently shown itself vulnerable to pressures from other governments to relax conditionality and increase disbursements. There is, in brief, no longer any effective management of the currencies of the neo-colonial system.

Let us now turn to the future. The folk memory of the century of price stability still powerfully influences popular perceptions: it is widely believed that this is the natural state of affairs, which will be restored when proper policies

are adopted, especially proper monetary policies. On the above analysis price stability seems very unlikely, whatever policies are pursued in the monetary field: the attempt to impose it would mean such a sharp deflation as to be politically unacceptable.

The requirements for far-reaching structural change are unlikely to moderate in the industrial countries. Further penetration of their markets will be difficult to avoid, with South Korea and the other newly industrialising countries following the example of Japan. The labour-saving innovations mentioned above will be introduced at an accelerating pace. Moreover, the defence industries will continue to grow more rapidly than the civil economy, especially in the United States.

Nor is there much sign that the obstacles to internal labour mobility are being dismantled, except for a reduction in real unemployment benefits and housing subsidies in some countries. The capital needed for reorganisation of each economy, including investment in new energy sources, is still being partly pre-empted by the increase in arms expenditure and overseas investment (especially investment in the NICs).

While unions have been weakened somewhat by the high levels of unemployment, it would be premature to expect them to acquiesce indefinitely in declines in real wages. Similarly the farm lobbies are likely still to be effective in protecting the real incomes of their constituents. The recession has caused the bankruptcy of many small firms and anti-trust legislation is being relaxed in the USA, so the degree of monopoly in the 1980s may well be higher than in the past.

In the United States the combination of big increases in arms expenditure and tax cuts seems likely to lead not merely to greater structural strains of the sort already discussed but also to continued, if not greater, budget deficits, facilitating the propagation of inflation. It is true that there are supposed to be big reductions in social expenditure and increases in tax revenues are predicted due to the stimulus to activity provided by lowering tax rates: this derives from the 'supply side' approach now fashionable in some circles close to (and in) the White House. However, that seems not merely highly optimistic but incompatible with another official doctrine, monetarism, which is specifically attacked by one of the exponents of this school, George Gilder (Wealth and Poverty, Basic Books, 1981).[23] The attempt to encompass both these doctrines is an apparent flaw in the economic philosophy of the Reagan administration: unless the stimulus provided by the tax cuts to income overwhelms the depressing effect of restrictive monetary policies.

Experience in the last two years in Britain, where a similar programme has been in operation, suggests that growth is not in fact at all responsive to a reduction in direct taxes. On the contrary, the consequence of this mixed package has been

that, in order to reduce inflation, the authorities here relied heavily on the one remaining policy instrument, the rate of interest. So in fact the national product has fallen, instead of rising, and tax revenues are much lower than expected. Moreover, the consequent increase in unemployment has created demands for redundancy benefits and welfare spending, making the difficult task of cutting public expenditure still harder.[24] As in Latin America, attempts to impose monetarist solutions, where the roots of inflation are not monetary, are proving counter-productive.

This comparison should not be pushed too far. The US economy is much more self-sufficient and flexible than the British: the obstacles to labour mobility are weaker and so is trade union power.[25] Nevertheless, there are other reasons for expecting inflation to continue in the industrial countries, maintaining the 'base rates' of world inflation. When inflation became fast, by historical standards, there was widespread support for counter-inflationary policies, but, as unemployment and bankruptcies became increasingly severe, and social unrest spreads, concern with inflation evaporates, monetarism becomes discredited, and political forces that favour the expansion of demand start to predominate. This has already happened in France and attitudes are changing rapidly in Britain too. Moreover, the main initial effect of a resurgence in demand is on productivity: so the demand stimulus will have to be large to make much impact on unemployment.

Inflation could well accelerate again at that point, especially if the expansionary policies take forms that aggravate 'bottle-necks', which have in many cases grown more acute in the last few years because of the low level of investment (eg in transport and communications) due to monetarist policies. Governments may find it not merely technically but also politically impossible to maintain ceilings on the money supply. The experience of Argentina and Brazil is compelling: even in an economy where monetarism is the official doctrine, and working class organisations have been weakened or destroyed, a military junta finds it impossible, as explained in <u>Discussion Paper</u> 168, to contain inflation.

An acceleration of inflation in the industrial countries could mean not merely that the base rates of world inflation would rise; in addition world liquidity would be increased by outflows of dollars and other acceptable currencies.

But we must not fall into the trap of concentrating attention purely on monetary factors. The basic strains in the world economy are after all what cause the growth in liquidity. The rate of world population increase is subsiding only very slowly, with declines in the birth rate being partially offset by continued falls in the death rate. It will not fall much below 1.7 per cent in the 1980s. In addition, the political

pressures for 'closing gaps' are by no means easing.

When world economic growth is resumed, the outcome could well be renewed increases in world oil prices. There have been signs in the industrial countries of oil consumption responding to the changed price relationships, and the income elasticity of demand may now have fallen below unity, at least the long-term elasticity.[26] But despite the repeated demonstrations of the dependence of industrial countries on imported oil, prospects are not favourable for accelerated development of domestic sources of energy. In the United States, the effects of decontrolling the price of domestic oil remain to be seen, while there, as elsewhere, public opposition is thwarting the development of nuclear power. Moreover, subsidisation of the development of new sources of energy is paradoxically being cut back, as part of the counter-inflationary programme! In the United Kingdom, even investment by the British National Oil Corporation (BNOC) has been checked by arbitrary limits to the 'public borrowing requirement' (which force BNOC to compete for funds with, eg the British Steel Corporation and British Rail, both of which have capital needs that are as insatiable as they are politically compulsive), and private companies complain that the tax regime makes further oil development unprofitable.

In 1981 oil prices started to ease, but the world oil market is only precariously balanced. Consumption is rising rapidly in oil exporting countries themselves, especially those with large populations - Mexico, Nigeria, Indonesia and Venezuela. There are prospects of increased output in new exporters (Egypt for example), but many governments will no doubt continue to hold production well below capacity (as Kuwait and Norway are doing). A great deal depends on the level of Saudi production, which is sensitive not merely to possible political upheavals in the (highly unstable) Gulf area, but also to changes in depletion policy, which could be influenced by US policy on Israel.

A resumption of economic expansion would also reveal shortages in many minerals (such as copper) where recently investment has been low, partly because of political uncertainties. Thus a number of potential bottlenecks in the world economy could inhibit expansion. Food output seems unlikely to grow at a faster rate than one per cent per capita. In addition to all the institutional obstacles, it is now increasingly affected by the higher price of oil-based inputs such as tractor fuel and fertilisers, especially in the many countries suffering from foreign exchange difficulties. Yet this rate would not be nearly fast enough to meet the needs of a resurgence of the world economy if oil supplies permitted this. The dangerous world food shortage which emerged in 1972 was subsequently alleviated more by a moderation in the rise of consumption than by a spurt in production.[27] So one can point to a latent food constraint, which the oil constraint temporarily masks.[28]

Yet the world economy is unlikely to become more flexible. Increases in oil prices continue to raise transportation costs and tightening protection is diverting demand to higher-priced domestic sources (eg of cars). While the expansion of bureaucracies may well have levelled off, the growth of world military expenditures is accelerating. Migration controls are hardly likely to be eased; indeed, the Middle East oil exporters are now showing increasing concern about the political implications of dependence on their immigrant workers, and are reducing their rates of expansion. Nor do political developments suggest that capital will flow more readily, especially for direct investment.

World liquidity looks likely to continue growing at a fast rate, not merely because of the probable easing of monetarist policies in the leading industrial countries, discussed above, but also because there is now a much greater pressure by the oil-importing countries, especially the NICs, and by their creditors, for increased lending by the World Bank and the IMF, and on easier terms.[29]

There seems little prospect that we shall again see hegemonic management of the international monetary system, such as that maintained by Britain in the 19th century, and the United States more briefly (and less rigorously) in the quarter century starting in 1945. Not even the United States is now capable of imposing political hegemony on the rest of the world - and if there is one lesson in the experience of Britain and other former imperial centres, it is that it is most unwise to attempt to hang on to power after the objective basis for it has disappeared.

Divergences in interests seem to rule out a 'collegiate' control by the leading industrialised countries, unless there is a very serious crisis, such as a Saudi revolution à l'Iran (and the monetary consequences of this could hardly be contained anyway). The European Monetary System limits (though it does not exclude) the possibility of exchange rate changes, but the Community has not so far acquired the technological leadership, the military power, or even sufficient agreement on policy to make the European Currency Unit a dominant world currency. The Arab oil exporters lack these requirements even more markedly, as well as the institutions to establish financial hegemony.

But the search for a new world authority of some kind is a chimera. Even if it could be created the implications of my analysis, at the levels of Latin America in Discussion Paper 168 as well as the industrial countries and the world, is that this is not a sufficient condition for price stability when major and difficult structural changes are necessary. To bring inflation universally to an end, for example, by reimposing a gold standard, could only be managed, as in the inter-war period, by deflationary policies so severe and so prolonged that the cure might well be worse for nearly all parties than

the disease - and could not be maintained.

There is thus good reason to expect a continuation in world inflation. Any government that promises to restore national price stability is talking about a variable over which it has only limited influence.

Ultimately, the stability of world prices is part of a much larger issue, the strength of the neo-colonial system as a whole. This - like the socialist system of Council for Mutual Economic Assistance, though in different ways - generates political and economic aspirations it cannot satisfy. World inflation is a symptom of this, just as inflation in any particular country in Latin America has been, in part, a symptom of unresolvable internal strains.

One possible solution would be to try to restore the viability of the neo-colonial system by increasing aid and private investment, facilitating further expansion of exports of manufactures from the NICs, and of advanced industrial products from the industrial countries, etc. This is the strategy spelled out in the Brandt Report and proposed in the 'New International Economic Order' by those in the South who have benefitted from the system. Policies of this kind may be attempted; yet their very success in stimulating world economic growth would aggravate structural tensions, especially the latent shortages of oil and food, but also the faster penetration of the industrial economies by TNC subsidiaries based in the NICs. The result would be an acceleration of world inflation, not its elimination, and the social costs in the industrial countries would be heavy.[30]

For them, the system in its present form is becoming perhaps too expensive to salvage. A strategy which is becoming more plausible would be to reduce the flows of private capital and aid and their inseparable companions, political and military intervention. This would respond to aspirations in many developing country governments for greater self-reliance. More limited regional economic blocs with a high degree of self-sufficiency could emerge, for example, the Western Hemisphere.[31] There is no space, nor is it necessary, to spell out the details here, but clearly in such groups it would be easier to establish and capital could more easily be mobilised, especially for the development of oil and other minerals. Such a bloc could become capable of covering its own energy and food needs by joint plans and long-term purchase agreements, and restricting the entry of manufactures, especially from Japan and the East Asian NICs, but allowing a good deal of competition internally. A successor of this type to the neo-colonial system would enable employment to be raised with less effect on the rate of inflation. It would also facilitate the preservation of world peace. Regional redistribution of economic power, and at least relaxation of migration controls within the region, would be indicated, but this is a much more feasible task than worldwide redistribution, or a general open door policy on labour movement.

But perhaps this would not go far enough to meet nationalist aspirations, for example in Latin America, and it may impose a politically unrealistic burden on the industrial and oil-exporting countries at the core of such a system. In that case, one could expect more culturally defined regional blocs - Latin America and North America as separate blocs, for example, rather than Western Hemisphere (which would not rule out a continuation, though in a different form, of a special relationship between Latin America and North America).

Until and unless such regional groupings become effective, national policies are bound to become more autarchic. Those of Latin American oil-importing countries, for example, will have to modify considerably the existing growth patterns in both production and consumption, which have involved increasing imports of energy and food and rapidly rising debt. So - except in Argentina perhaps, which is self-sufficient in essentials - inflation seems bound to accelerate these. It is important for all parties that governments in the industrial countries should see the logic of these developments, and not try to preserve the neo-colonial system by concluding unrealistic international agreements (based on NIEO) by attempting to re-establish a strict global monetary system, or by political or military intervention.

NOTES

1. The data in this paper were kindly provided by the International Monetary Fund; the (weighted) geometric mean used to average national consumer price indexes is less affected than an arithmetic mean by the very high rates of inflation in a few countries.

2. The unit value index of world food trade (fob) rose by 36 per cent between 1972 and 1973 (1979 Trade Yearbook, FAO, 1980).

3. The classification is somewhat arbitrary. Each of the factors that normally propagate inflation could in principle help initiate it. Moreover, some factors are linked: thus the population increase was partly responsible for increased dependency on imports of food and oil, and what is shown as an obstacle to structural change can also be a reason why it is needed (eg transportation inadequacies).

4. Serjit Bhalla in William R. Cline and Associates, World Inflation and the Developing Countries (The Brookings Institution, 1981) does in fact come to the conclusion that for the 29 developing countries covered in his econometric study for 1956-75, neither monetary nor structural factors are adequate in themselves. A hybrid is necessary. He obtains a higher 'explanation' of increases in consumer prices by allowing not only for relative food prices but also import prices, in addition to the money supply. I am hesitant about relying heavily on this as supporting evidence, however, because of doubts not only about the quality of price data but also whether regression between time series can bear sophisticated analysis, and measure the impact of the factors in a complex inflationary process that can vary so much between periods, especially since the choice of dependent variables to be tested seems arbitrary and omits non-quantifiable factors.

5. The base rate is in a degree regional: the rates of inflation in the United States and El Salvador have been roughly similar. Similarly, Japanese inflation now provides a base rate for East Asia, French for Francophone West Africa, German for Southern Europe, etc.

6. Anglophone economists do not seem to have been very successful (either the Keynesian or the monetarist schools) in analysing inflation and prescribing remedies in their own countries. Perhaps an approach based on Latin American experience may be more fruitful.

7. It would also be interesting to apply this framework to the socialist countries of Europe which show many of the same structural problems, compounded in some cases by even greater bureaucratic resistance to economic change; I have neither the knowledge nor the space to attempt this here.

8. Although the trade unions are stronger than in Latin America, we should not forget the lesson mentioned in Discussion Paper 168, that breaking the power of the unions and relaxing indexation does not prevent fast inflation (even in Argentina at a 3 digit rate).

9. 1979 Production Year Book, FAO, 1980.

10. Some food is redistributed by food aid, but this declined in absolute terms during this decade (Food Outlook, FAO, 1979).

11. 1979 Trade Year Book, FAO, 1980. The price of wheat (No 2 Hard Red Winter fob Gulf) which had been fairly stable up to 1972, at below $2 a bushel, jumped to over $4 in the mid 1970s.

12. Reserves did, however, temporarily rise again in the late 1970s as major new discoveries were announced, especially in Mexico (and world oil consumption grew much more slowly).

13. Between 1970 and 1973, more than 80 per cent of total mineral exploration in the non-socialist world was concentrated in Australia, Canada, South Africa and the United States (UN Development Forum, 1978 : 1). The developing countries' share of European companies' total exploration expenditures fell from 57 per cent in 1961 to 13.5 per cent in 1973-75 (The Courier, Brussels, 1978, No 49). See Gerald Helleiner, Intra-Firm Trade and the Developing Countries, Macmillan, 1981 : 23. Peter Odell estimates that 'Latin America, Africa and S.E.Asia contain almost 50 per cent of the world's total potentially petroliferous regions (excluding Antartica and the deep oceans). To date however petroleum development efforts in these regions have been minimal. They have amounted - and continue to amount - to less than five per cent of the worldwide effort' ('Oil and Gas Potential in Developing Countries and the Prospects for its Development', Economisch Geografisch Instituut, Rotterdam, Working Paper Series A, 1980, No 1).

14. Tony Killick, 'Eurocurrency Market Recycling of OPEC Surpluses to Developing Countries: Fact or Myth', in Christopher Stevens (ed), EEC and the Third World: A Survey, Hodder and Stoughton for ODI/IDS, 1981.

15. See Gerald Helleiner, 'World Market Imperfections and the Developing Countries', in W.R. Cline (ed), Policy Alternatives for a New International Economic Order, Praeger, 1979. In his 1981 study cited above (p 10) he shows that in 1977 48 per cent of US merchandise imports originated in 'related parties' (ie firms with at least five per cent US ownership of the voting stock). This excludes the sales of companies linked more loosely to US corporations. (Comparable data are not available for

other industrial countries.)

16. As Robert Triffin has pointed out on a number of occasions (for example in a paper presented at a conference in IDS in June 1980), this outflow was not, as is often mistakenly alleged, due to deficits in the United States current balance of payments. Broadly the current account was in balance at this time, taking one year with another. The point is that there was no surplus in it in spite of the returns on past investments (which appear as a credit in the current account, even if never remitted home). Yet a big surplus was needed to finance the heavy outflow of capital, especially foreign aid and the big investments overseas.

17. Moreover, Special Drawing Rights were now being issued. The initiative to create these was taken in the 1960s, when there were (justifiable) fears of a shortage of international liquidity. By 1970 when they were actually first issued, total reserves were ceasing to be inadequate but SDRs were able to take on a different function, supplementing the dollar as a unit of account. See James Morrell, The Future of the Dollar and the World Reserve System, Butterworth, 1981.

18. An explanation of the association between changes in reserves, monetary stocks and price rises in the late 1960s and early 1970s is to be found in Robert Heller, 'International Reserves and Worldwide Inflation', IMF Staff Papers, March 1976.

19. Political power seems to play an even bigger role in world price trends than for individual countries. The reason, perhaps, is that governments do not have such difficulty making possible the movement of goods, labour or capital from one part of a country to another.

20. Manfred Bienefeld has pointed out to me that Kenneth Galbraith drew attention to the positive effects of 'financial irresponsibility' in the United States in the 19th century, especially in the high risk expansion of the frontier Westward: no doubt this could be accommodated successfully because of the immense yields in foodstuffs and minerals (which also made it unnecessary for the United States government to mount a military challenge to British hegemony).

21. The price rise would have been even faster but for a duopsonistic system of purchasing commodities run by the governments of Britain and the United States.

22. The dollar has continued to be treated as a prime asset, just as earlier sterling continued for some decades as a reserve currency after British hegemony had been undermined.

23. It also differs from a structural approach, however (which emphasizes the supply side too), in being highly aggregative: it focuses attention on the presumed elasticity of total output with respect to changes in tax rates.

24. Indeed in Britain where - as now in the United States - a series of annual reductions in income taxes was planned, there was only one and this was partially reversed subsequently (in the sense that personal allowances were not adjusted for inflation).

25. In the UK more than half the non-agricultural employees are in unions and the proportion was rising in the 1970s; in the US the corresponding ratio is less than a quarter and the trend has been downward.

26. The 1973-78 average growth rate in world oil consumption was 1.3 per cent (even lower if one excludes the Soviet bloc) compared to over 7 per cent in the 1960s. This does, however, reflect a response to rising prices as well.

27. See Raymond Hopkins and Donald Puchala, Global Food Interdependence, Columbia U.P., New York, 1980 : 18, for an assessment, from a liberal US viewpoint, of world food trends and prospects, including prospective deficits in the 1980s. See also Global 2000, Report of the US Presidential Commission, 1981.

28. There is now a link between food and oil supply, because some food crops can be converted into ethanol. (A second, weaker link is that off-shore mining interferes with fishing.) Consequently, as oil prices rise, more land will be used for fuel crops, and the reverse will happen as they fall. Because of time lags, one constraint or the other will always be dominant, but in the longer term there will be single land use constraint.

29. Also central banks have not fully revalued their gold stocks. When this happens (eg on their sale), their assets will rise, permitting a corresponding increase in their liabilities.

30. See my 'North South: Muddling Morality and Mutuality', Third World Quarterly, October 1980, Vol II, No 4.

31. See my 'The Second Enlargement of the EEC in Historical Perspective', in Dudley Seers and Constantine Vaitsos (eds), The Second Enlargement of the EEC: Integration of Unequal Partners, Macmillan, forthcoming, also as an IDS Discussion Paper 158, for a discussion of the possibility of greater self-reliance in Western Europe. A move in this direction in the Western Hemisphere is the Mexican-Venezuelan undertaking to supply oil to the Caribbean on easy credit.

Bulletin vol 13 no 1
December 1981

'Monetarism': its effects on developing countries

editors: Stephany Griffith-Jones and Dudley Seers

Monetarism, which has been an important strand in economic theory for several decades, has recently been spreading like a forest fire, with drastic economic and social effects The impact on developed countries has been very widely discussed in academic journals, no less than the popular press: this *Bulletin* focuses instead on the effects of the doctrine on developing countries. These effects are partly indirect, through world recession and the influence of the IMF; but also imported theories of monetarism are reflected in the policies of a number of governments. Case studies are provided of the Southern cone' countries of Latin America, especially Chile, where monetarist medicines are taken neat, and South Korea, where they have been diluted with a dash of pragmatism.

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ISSN 0308-5864