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A Brake for the Inflation Merry-go-round

The die is cast for the business cycle policy. Under somewhat spectacular circumstances the Federal German Government made up its mind to come out with a package-deal whose most important constituent, the floating exchange rate, is still so unorthodox a measure that it is regarded almost as sensational. As to the rest, the package resembles a medical operation which finally had to be decided upon because of all hopes for the patient's improvement having proved deceptive. All the same, though, and to carry the comparison a step further, the state of health of the patient, the economy, has meanwhile already been weakened as a result of the fever's long duration. What price would the "surgeons" not be ready to pay today, had they performed the operation considerably earlier!

But must they suffer to be reproached on account of it? Most who do reproach them for the delayed action, obviously do it because of lack of knowledge of the course of the disease. The Federal Government can undoubtedly be reproached with many shortcomings of its economic policy. In the past 18 months an abundance of errors in leadership and clumsiness as well as vagueness were shown. The present "Operation Stability", too, is anything but a tactical masterstroke. No, what strikes the eye are the diagnoses on which the Government orientated its policy which, in the wake of the findings, was practised for better or worse. In defence of the Government's line it should in all fairness be said, though, that it fell a victim to the diagnoses. The Government has had a taste of the very weaknesses that are so typical of the applied sciences, and thus also of economics.

Seen in the light of the history of this fifth business cycle since the war, this sort of thing goes a long way to explain the ill-course of events. But this is not applicable to the point of departure for the evil, the fatal misjudgements by the Big Coalition in the field of foreign trade policy incurred in 1968 ("Ersatz"-revaluation) and again in May, 1969 (rejecting revaluation). In those cases, no politician can come forward with the pretext of having been wrongly advised by science. What matters now, however, is the period after the much belated October-1969 revaluation.

In the early summer of 1970 production heralded the downward trend of the economy whilst prices continued to rise sharply. The experience of the cost and prices development always following the economic trend with some delay gave, at the time, encouragement enough for confident forecasts: costs and prices, so it was argued, would eventually find their own level if the dampening of the economy would continue for a while yet. Only very few observers sensed that, what might actually be happening, was quite a novel phenomenon, namely prices rising independently of the business cycle. At the time, however, this could have been no more than a hunch which, moreover, had been heard of already in the early 'sixties but without then having been substantiated by the subsequent economic development.

Actually, the findings became quite clear only recently. As there still was an undiminished prices and wages rise, the hypothesis of delaying effects could no longer serve as the explanation. Obviously, the development of wages and prices runs today independent of the economic trend. There is a playing-it-up between them, and finding that supplementary condition on the open flank of foreign trade policy which does allow for this unholy game to go on almost limitlessly in

an inflationary atmosphere. There is no doubt: the prices and cost rise (without the sequence of the words meant to be at all indicative of the causality) is not only more pronounced than at any time during the last 20 years, but also the danger of automatically intensified dynamics of instability has never before been so great. It would be irrelevant to try and find the cause foremostly in the near enough grotesque shortcomings of the international monetary system. The flood of dollars, for the whole world, except only the United States itself, a most unpleasant problem, was, and remains, merely an abetting fringe circumstance (the reaction of official American quarters, composed as it has been, can hardly be called other than cynical). But by and large the tendency of rising internal prices is "made in Germany".

Without determined steps to stem this trend, the danger of irreparable damage would have been the result: the growing impression that in Germany an economic catch-as-catch-can was now openly licensed. If the Government, faced with the unveiled negation of any economic reasoning by both social partners, and individually by many groups of the society, would have failed at the present time to become active, this would undoubtedly have been synonymous not only with the departure from all up to now prevailing conceptions of money stability, but also have enhanced the decline of political authority. Stability policy is today, more than ever, also a test of strength in discussions with directly interested groups who, because of their licentiousness, could become a danger for democracy as we know it.

The "how" of stability policy is at the moment somewhat secondary to the "if", but the success will of course depend on the "how" in the first place. It must be emphasised from the outset that all too little would be gained by the cutting off of the foreign exchange inflow alone. This follows from the fact that this inflow's impact has been furthering rather than actuating. The core of the problem is the checking of the inflationary forces on the domestic front. To do this it is however necessary to shield the stabilisation process against ill-influences from without. This, again, is not achieved by merely preventing a further inflow of foreign exchange. What is required is a neutralisation of those influences that make themselves felt on the internal level of prices via the inter-connexion of international price movements. This is necessary once and for all, and the only means to do it is flexibility of exchange rates in whatever form. Although flexible exchange rates are in the long run incompatible with the EEC, at least not compatible with a "genuine" economic community, this argument will not be very weighty for some time yet. But the premature announcement for instance by the President of the Federal Bank that one hoped after some time to go back to the old parity is not a good omen. On the one hand this attitude is unrealistic and, on the other, encroaches upon the success from the outset. Because what does matter especially is the exercising of an influence on expectations.

In having now decided also upon restrictive measures internally (curtailing the increase of public expenditure, increasing the economically balancing reserves), the Federal Government has gone beyond the recommendations of the German Research Institutions made in their joint diagnosis. The Institutions aimed at avoiding with the largest possible degree of certainty the danger of unduly strongly applying the brakes for the economy, as it had already become unstable. The fact that the Government, in view of the existing degree of instability, yields comparatively little to this risk, goes a long way to demonstrate its resoluteness to counter the danger of inflationary dynamics. The plainness of this determination is a vital pre-condition for the success of the intentions. But much also depends now on the attitude of employers and employed. It would, however, surely be a mistake to expect quick results shown in the price-index. To the contrary, it will for some time to come still reflect what had been stocked up in the past. It also depends on the length of time, and the actual doses, of the various measures as to what degree of success will in the end have been achieved. But the decisive step has been taken. It is the negative reply to all who misjudge the economic and social significance of price stability — a stability, as it were, already applying in a relative sense only.

Hans-Jürgen Schmahl