

Ziercke, Manfred

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Effects of Post-War Inflation

by Dr Manfred Ziercke, Hamburg

For more than twenty years, economic development in the Federal Republic has been subject to two principal factors: steady growth of the GNP, in real terms, and equally steady creeping inflation. During the 'fifties, the West German economy had been growing mostly under conditions of annual inflation rates of 1 to 2 p.c., while the price level rose much more rapidly during the 'sixties. After the fifth post-war boom had reached its summit in spring 1971, the inflation rate hit a new high of 4.5 p.c., the steepest increase since the Korean War inflation. Against the acceleration of price rises, the fight is being waged in the Federal Republic using conventional methods — monetary and fiscal restrictions. As an additional measure to meet inflation only recently floating exchange rates were introduced. Many economists believe, however, that West Germany now lives under the treat of an even deeper recession than 1966/67 or, possibly, even under that of an American-type "stagflation",

Relevance of Price Stability

There is almost unanimity among the important economic groups in the Federal Republic that inflation is socially intolerable because it operates to the disadvantage of selected groups, bringing about an "unjust" distribution of incomes¹. To support this view, argument runs approximately along the following lines:

The main sufferers from inflation are old-age and private pensioners, because their unilaterally fixed incomes are not, or only incompletely, being adapted to correspond to the rise of the price level;

Employees have to accept losses from inflation, because their wages and salaries will follow rising prices only with a time lag;

Creditors suffer from inflation, because the value of their monetary assets decreases, in real terms.

¹ See, for example, *Geschäftsbericht der Deutschen Bundesbank für das Jahr 1968* (Annual Report 1968 of the Federal German Bank), Frankfurt/Main 1969, pp. 27 et seq.

However, when considering the objective to "keep the price level stable"², these hypotheses often are not examined carefully.

The Impact of Inflation on Pensions

Any price increase will reduce the real value of pensions, which are fixed in nominal terms. A neutralisation of such inflation induced devaluation of pensioners' real incomes can only be effected by a decision of the institutions or persons, fixing the transfers, the first of which was made in the Federal Republic in 1957³. Old age pensions of workers and white-collar employees have been "dynamised", and from 1959 onwards, they were periodically adjusted to the overall income level of employees. At the time of writing, government grants for "dynamised" pensions were of the order of DM 10 bn p.a. Part of this total may be considered as the contribution of society at large to protecting pensioners against inflation.

Except in 1962, 1963, and 1970, the amounts by which pensions were increased were more than double the size of corresponding annual inflation rates. Yet from this it cannot be concluded that pensioners have been fully protected against inflation, or may have even been overcompensated for their inflationary losses. From 1959 onwards, existing pensions are being adjusted in line with their "general basis of calculation"⁴ only with a time lag. On the other hand, the effect of this statutory time lag is being considerably mitigated by the rule that only part of both pensions and pension increases is subject to income tax. In contrast to these pensions assistance payments

² See Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft, § 1, in: Bundesgesetzblatt (Law for Promoting Stability and Economic Growth, sec. 1, in Federal Law Gazette) 1967, Part I, p. 582.

³ See Begründung des Gesetzes zur Neuregelung des Rechtes der Rentenversicherung der Arbeiter und der Angestellten (Reasons Given for the Act to Reform the Old-Age Pension Law for Workers and Employees) in: Bundestagsdrucksache 11/2437, Bonn 1956, pp. 57 et seq.

⁴ The general basis for calculating pensions is the three-year average earned income of all insured persons, prior to the calendar year completed before the insurance claim arises.

by the public Accident Insurance, dynamised in 1963, have been tied more closely to the rise in current incomes. And civil service pensions are even directly related to the level of civil servants' salaries. But again, pensioned-off civil servants are at a disadvantage, compared with other pensioners, because civil service pay is not rising as quickly as other wages and salaries. Other recipients of transfer income, e.g. pensioners of private pension funds, must accept relatively higher losses from inflation, because their income is seldom linked automatically to rises in the price level. It might be possible, however, to reduce the inflationary burden carried by this group, or even to evade it, by suitable forms of "dynamisation", as has been done in many cases of life-annuity policies⁵. Other forms of compensation, for example dynamising rent supplements to make up for rising rents, might also serve to protect individual pensioners against the impact of inflation.

Losses of Employees?

Inflation will cause a redistribution of income at the expense of employees when wages and salaries follow rising prices only with a time lag. Yet the first observable fact is that real income per average employed person has increased every year in the Federal Republic. During the years of inflation from 1950 to '55, except in 1954, wages and salaries have not advanced quite as much, as both labour productivity and price level together. Therefore it might be argued that employees had to accept, during this period, small losses in real income through inflation. Then, from 1956 to '59, except in 1959, earnings per average employed person rose almost at the same rates as both price level and labour productivity together, which means that employees more or less were able, in this period, to avoid inflationary losses. And throughout the 'sixties, as well as in 1970, the functional distribution of incomes has even changed slightly in favour of employees.

During the upswings of the economy, i.e. in 1959, 1963/64, and 1968, wages did not rise as quickly as National Income per working person. And during 1967, the year of recession, monetary wages per average employed person rose only by 3.4 p.c.—the lowest rate since 1950—,making evident that in a period of weakening overall demand people in dependent employment have to renounce increments in income and, in some cases, must even accept unemployment and/or short-time working. Considering that low inflation rates have been characteristic of both the years of gradual growth and those of recession, in contrast to

years of a pronounced boom, we may come to the conclusion that, at least in those years, inflation was not mainly responsible for the lacking adjustment of wages and salaries to rising prices and labour productivity. The whole development seems to show that workers, employees, and trade unions have been able, at least from 1956 onwards, to forestall the effects of creeping inflation in the Federal Republic and to include the presumable rate of inflation in their wage demands.

Obviously, it cannot be denied that some groups of people in dependent employment, e.g. civil servants and public employees, do suffer losses from inflation, because their monetary pay cannot be adapted to the rising price level without a time lag. Such losses by specific groups could be reduced or even avoided if their salary agreements contained escalation clauses. However, current law in the Federal Republic, which permits escalation clauses for instance in renting and leasehold agreements, does not allow the inclusion of rules tying wages and salaries to price indices. On the whole the burdens imposed on West Germans in dependent employment by inflation have nevertheless not been considerable, as far as current income is concerned. Even if the time lag in adjusting all West German wages and salaries during the years 1950–69 were one year, DM 36 bn would account for the loss from inflation, a small amount if compared with the overall total of wages and salaries of DM 2,696 bn. And if we assume that wages did no longer lag behind the prices after 1960, the redistribution of incomes at the expense of employees drops to DM 7 bn over a ten years' period, during which no reduction of real earnings was registered.

The Losers: Government and Private Households

Inflation leads to a redistribution of purchasing power from creditors to debtors, as long as monetary debts are expressed in fixed sums of a given currency, and as long as the rate of inflation is not allowed for by the nominal rates of interest or debt redemption.

In the Federal Republic, inflation rates have been, for some years, equal to, or higher than, the bank rate or the rate of interest on savings. At least during some years lenders and savers were not able to anticipate the rate of inflation successfully in these rates of interest. This is also true of other rates of interest, because the West German interest structure was determined, in these years, mainly by agreements.

But it is not possible to determine the actual redistribution of purchasing power from creditors to debtors, because there is no way of calculating the extent to which the rate of inflation was antic-

⁵ See W. Dürkes, *Wertsicherungsklauseln (Escalation Clauses)*, Heidelberg 1966, pp. 24 et seq., 171 et seq., 248 et seq.

ipated. An estimate, however, of the overall purchasing power redistributed from creditors to debtors by inflation can be made, assuming inflation has not been anticipated at all, on the basis of sectoral credit relationships between private households, enterprises, the public sector, and the foreign sector. The inflation induced losses and gains, respectively, may then be estimated for every year by multiplying the annual inflation rate with the annual average monetary net credit or debit balances. These estimates represent a ceiling, because the actual transfer of purchasing power will be smaller, if the rate of inflation is anticipated in part or wholly, in the rates of interest. As the sectors making gains or losses from inflation, arising from credit relations between private households, enterprises, the public sector, and the foreign sector, the following may be highlighted:

The main sufferers from inflation are private households who, at the same time, are savers. Their potential loss through inflation, in 1950–69, in prices of 1969, may be estimated at DM 53 bn⁶. Particularly badly hit are those who save through small deposit accounts, mainly employees and pensioners, whilst households owning real assets, e.g. real estate, are usually able to evade or to make up for most of the inflationary losses, as their funds have largely been used for acquiring real assets, which are an effective hedge against inflation. Landlords, including building societies, for example, have profited from the devaluation of mostly interest-free government housing loans, granted for low-income housing, by an amount of roughly DM 15 bn. Effective losses suffered by households and/or savers are at any rate lower if parts of the savings and housing bonuses, income tax allowances on special expenditure, etc. are considered as compensation for the decreasing real value of savings accounts.

The public sector as net creditor has also lost through inflation. DM 31 bn account for its potential loss. But Government losses through devaluation of its credit balances are in part compensated

⁶ See also M. Ziercke, *Die redistributiven Wirkungen von Inflationen (Redistributive Effects of Inflation)*, Göttingen 1970, pp. 128 et seq.

for by income tax progression because, for example, taxpayers whose monetary incomes rise through inflation, whilst their untaxed real incomes remain unchanged, have to pay progressively rising taxes.

Main beneficiaries of inflation have been entrepreneurs and enterprises, respectively. The ceiling of their gain through devaluation of their debts reaches about DM 71 bn. Enterprises profit from inflation the more, the higher their indebtedness rises. Housing companies, whose projects are mainly financed from borrowed funds, and manufacturing companies which, in Germany, operate with exceptionally high indebtedness gain especially from inflation, whereas banks, as net creditors, are losing from it.

Profiteers from inflation were, lastly, also foreign borrowers to the extent of about DM 13 bn assumed that inflation has not been hedged against by their creditors.

Compensation Possible

Inflation rates which have been rising since 1966/67, have induced many economic groups to change their behaviour with respect to inflation. As to private households, in 1969 adjustment to inflation has caused the growth of deposit savings accounts to slow down, in spite of rising incomes, while the number and volume of new housing savings policies and the demand for building sites and owner-occupied dwellings has expanded. Small savers, whose assets are held mainly in the form of savings deposits accounts, are rarely able to hedge against inflation by rearranging their portfolios, because they lack the knowledge and information about economic development, the presupposition for a "rational portfolio selection". In addition, the costs involved in rearranging investments would be too high for this group of investors. Such "small savers" might be protected against inflation by the introduction of escalation clauses to guarantee the real value of savings deposits. Another form of protection could be the granting of savings bonuses, which are not tied to long notice for withdrawals, but are dependent on the average annual balance.

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And finally, small investors might be offered, for their protection, shares in real property (e.g. in local government owned land), but with a guarantee that such assets will always be convertible into cash.

The results of our investigation achieved so far—recipients of income transfers and private households, especially small savers, who are mostly pensioners and employees, have to accept inflationary losses—can, however, not satisfy completely the aims of our enquiry into income redistribution through inflation. For this presupposes, as an alternative, an income distribution existing in a state of monetary equilibrium. What is needed for a conclusive assessment, therefore, is comparing the effects of redistribution by inflation with the effects of all the measures taken for fighting the inflation.

A Costly Fight Against Inflation

A criterion for such a comparison in the Federal Republic can be derived from the loss of production during the recession 1966/67, which amounted to nearly DM 40 bn⁷), if this loss is regarded as the costs of achieving relative price stability. Held against this total, the redistribution of purchasing power caused by inflation may be considered as "socially tolerable", because the "costs" for relative price stability in 1967 and 1968 represent almost half of the potential redistribution from creditors to debtors in 1950–69. Moreover, specifically those groups suffer most from inflation—pensioners and employees who, at least as small saver, carry the burden of inflation—who would also be adversely affected by anti-inflationary measures leading to a general recession: the recession of 1966/67 either deprived employees of a rise in income, or even caused an actual loss of income through unemployment and/or short time working. It is true that profits fell even more steeply during the recession, but after the recession had ended at the turn from 1967 to 1968, this kind of income rose much more rapidly than income from dependent employment. Due to the institutional time lag in dynamised pensions, most recipients of transfer incomes suffer from the general stagnation of incomes in 1966/67 only now.

In view of these findings and of rising rates of inflation during 1968–71, a production loss of nearly DM 40 bn appears as too high a price for a relatively stable price level only during two years, especially as it is possible to introduce escalation clauses and other forms of protection against inflation.

Depending on the kind of anti-inflationary measures their consequences might be more serious

than the social consequences of inflation. It is therefore questionable whether a creeping inflation should be avoided at any price. At the same time the "price" for stability has to be considered when judging the redistributive effects of inflation.

New Policies Needed?

To make a rationally through-out economic policy possible, it is necessary to foresee clearly the potential effects of alternative methods for fighting general price increases. In this connection, it must not be overlooked that inflation in the Federal Republic is not due to one single cause and therefore cannot be overcome by a simple prescription. Tying our discussion to a single average and overall rate of inflation will moreover prevent us from discerning differing price movements in individual sectors of the economy.

This is why it will be necessary to discuss, not only if the general macroeconomic monetary and fiscal measures to fight inflation, used nearly without exception in the past, have been efficient, but also whether an institutionalised inflation in a growing economy, for which perennial structural changes are characteristic, could not be countered for instance by structural measures more effectively than so far.

Particular urgency is attached to this question in the Federal Republic where building costs and housing rents are showing an above-average rise relative to the general price level. Potential owner-occupiers and tenants are scarcely able to hedge against this type of inflation on their own. West German credit policies have for a longish period been wedded to tight money, which caused high interest rates. This has made building capital dear and has raised rents.

Any successful fight against inflation ought to be aimed at particularly inflationary sectors and their shortcomings—in the building industry, for example, aiming at higher sectoral labour productivity, at favouring technological innovation and its rational uses, at measures to increase competition, and at fighting excessive rises of land prices.

In addition, we should try to counter the spreading of public expectancy of further inflation which, by numerous recent and provocative writings in the daily press, threatens to become an inflationary psychosis.

⁷ See Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 1967 (Experts' Council to Report on Overall Economic Development, Annual Report 1967), Bundestagsdrucksache V/2310, Bonn 1967, p. 55 under No. 83.