

MONETARY POLICY IN A COST-PUSH INFLATION ENVIRONMENT — GHANA, 2011

Introduction

Developments in international commodity markets point to continued price escalation of food and oil. And limited fiscal space means that full cost recovery cannot be avoided in domestic prices of the affected products in the course of 2011. Monetary policy would therefore have to face the challenge of the cost-push inflation resulting from these arguably “temporary price shocks”. Specifically, the BOG, in its interventions, must seek to prevent the price surges from translating into persistently higher pressure on inflation.

The evidence shows how over time, temporary price pressure becomes entrenched:

- consumer inflationary expectations could rise, or
- workers could demand higher wages — an issue more for the Fair Wages and Salaries Commission (FWSC) and outside the control of the Bank of Ghana

In some countries, high unemployment could be counted upon to keep workers from demanding excessively high pay rise. And without compensatory higher wages, rising food and petroleum product prices would reduce real wages and cut its consumer spending. In turn this would lead to lower not higher inflation down the road. There is the question of wages policy in Ghana and whether in an election year workers will accept their real wage erosion or trigger a price wage spiral. In a relatively slow-growing economy with high underemployment and unemployment, the macroeconomic policymaker can only hope that those without jobs restrain the demands of those in work.

Loose monetary policy stance would undoubtedly pose a real risk of a persistent inflation problem. This, however, need not be exaggerated. Inflation is a cause of legitimate concern but need not always be a cause for panic. Concern about the inflation tax and its cruel consequences for the poor is morally justifiable but the poor do have inflation hedges.

Monetary policy by itself may not be successful in any case as the evidence strongly suggests. In an economy, such as Ghana's, characterized by fiscal dominance, monetary policy is apt to be overwhelmed by expansionary fiscal policy. Thus tighter fiscal policy with complementary monetary policy to slow-down aggregate demand is the appropriate macroeconomic policy mix. The recent 18-month spell of disinflation illustrates this point.

Inflation cannot be fought on the cheap. That there is no long-run trade-off between unemployment and inflation is firmly established and affirmed in a recent BOG research in Ghana. There is, however, an equally well established finding of a short-run trade-off. The Keynesian quip that in the long-run we are all dead is to demand that near to short-term problems must be properly diagnosed and dealt with and not glossed over by reference to the long-run. As Nobel Laureate Joseph Stiglitz put it: Economists do themselves a disservice when they take such a stance. It is saying to people in a boat on stormy seas that they should be patient and persevere because as soon as the storm is over the sea will be calm! What is also true is that the quantitative dimensions of this short-term trade-off differ from country to country and from time to time even in the same country — the so-called sacrifice ratio is not fixed over time and space.

The Phillips Curve Controversy

The short-run trade-off has been widely misinterpreted to assert that inflation must be low when unemployment is high and high when unemployment is low. As a result when high inflation and high unemployment occurred together in the USA in the 1970s many observers wrongly declared the so-called and much maligned Phillips Curve dead and conventional macroeconomic analysis bankrupt.

This misinterpretation came in both left-wing and right-wing versions:

Left-wing version — unemployment could not and therefore should not be used to fight inflation.

Right-wing version — the battle against inflation could and should be fought without worrying about higher unemployment.

If we attempt to maintain low unemployment by running a high-pressure economy, we run the risk of exacerbating inflation. And if we want to beat down inflation then economic slack is our strongest and surest weapon. We may wish that it was not necessary to tolerate high unemployment in order to reduce inflation. But the facts suggest otherwise.

The price of any item is determined by both supply and demand. So when a price increase is observed it is important to find out why. If it is because consumers suddenly crave more, producers can be expected to expand production. If, on the other hand, the price rise is on account of a “harvest failure” production is down.

More generally where fluctuations in demand are dominant and the supply schedule is relatively ‘fixed’, we should expect price and quantity to rise together as we travel up and down the fixed supply curve. On the other hand, supply schedule fluctuations with demand schedule fixed would result in a price and quantity going in opposite directions. “If the fires of inflation are stoked by contracting supply, then sluggish growth and rising unemployment accompany inflation”. The unsavory mix of stagflation occurs.

Making the Best (or Worst) of a Bad Situation

The fact of stagflation — unemployment and inflation rising together — does not mean that policy makers no longer face a trade-off between inflation and unemployment. Bad luck does not obviate the need for choice, nor even the importance of making the right choices. To illustrate:

when a tropical storm brings heavy rainfall with flooding, I can still use my car. But I must make an uncomfortable decision. If I drive at the speed I would choose in good weather, my trip will be more hazardous than usual. If instead I crawl along at snail’s pace, my trip may be as safe as it would be on a dry pavement, but it will take longer. Flooding precludes the combination of safety and speed routinely enjoyed on dry pavement. I must choose how to accept the loss the flooding imposes on me.

Those who control fiscal policy — taxes and government spending — and monetary policy — the money supply and interest rates — must similarly lower their sights when a supply shock hits. Supply shocks, like harvest failures and oil price hikes, aggravate both inflation and unemployment. If policymakers try to keep unemployment from rising by maintaining aggregate demand and uninterrupted growth in real GDP, inflation would worsen. And if instead they try to hold inflation down by deliberately slowing the economy, unemployment will surge. They must take their lumps in the form of higher unemployment, higher inflation, or both. The key question is where to strike the balance. In situations like this “it is unpleasant to be sitting at the interest rate controls”. The BOG (and Ghanaians in general) may have to accept higher inflation and lower growth in 2011.

Box 1: OPEC I and OPEC II

The result of the more or less deliberate strategy of using economic slack to fight OPEC I and OPEC II was more than a decade of anemic economic growth in most countries, ominously high unemployment and low investment in Europe, and a disheartening collapse in the export markets of many poor and debt-ridden developing countries. Yes, the inflationary dragon, if not slain was at least badly wounded. But the citizens of the world paid a heavy price for reducing inflation and keeping it low.

One may ask of this experience:

- did we strike a good bargain?
- or, like Faust, did we pay too much?; and
- what, precisely, have we gained by reducing inflation

Conclusion

Asked what he had learnt from the Bank's poor inflation forecasts, Mervyn King said he had learnt only that: outcomes for inflation.....can be explained by unexpected increases in energy prices and commodity prices including food prices. He reportedly asked: "would you have had us deliberately raise interest rates by a significant amount in order to induce a much deeper recession, raise unemployment in order to push money wages down in the way that it has happened in Greece, Ireland and Portugal in order to meet the inflation target in the short-run?" (FT Feb 17 2011, page 3)

The Governor had "enormous sympathy" for people suffering a squeeze on their living standards from high inflation, but that squeeze "was going to happen one way or another — it is the price we are all paying for the financial crisis"

In King's view:

There is no black or white here. These are difficult judgments and anyone who is absolutely certain that a certain course of action is right or wrong is exaggerating the degree of certainty about the future.

Economists have been thinking about, studying, and trying to measure the social costs of inflation for decades. A central conclusion of this research is that the costs of inflation depend very much on whether it proceeds at a steady, predictable rate or is volatile and takes people by surprise. Inflation is clearly unloved. But is this popular aversion to inflation based on fact and logic or an illusion and prejudice? After, all public opinion, it must be remembered, also lines up solidly behind the existence of flying saucers, angels and extrasensory perception.

Box 2: Medium-term Challenges in the United Kingdom

The MPC collectively cites four reasons why the balance between output and inflation has deteriorated and will keep inflation higher for longer and this partly justifies the speculation over the need for tighter monetary policy:

- the MPC thinks businesses would seek to raise profit margins hit by sterling's fall in recent years and higher import prices;
- the ability of the economy to supply output has been hit by the financial crisis and lack of investment, so the MPC has reduced its assumed degree of spare capacity to “ reflect a loss of underlying productivity which is likely to persist throughout the forecast period and possibly beyond;
- there is a small effect from raised inflation expectations because it expects businesses to raise prices and wages faster in anticipation of higher inflation; and
- employees would resist the squeeze in living standards and demand higher pay rises.

The combined effect of these over the medium-term is a downward revision of growth forecast by 0.25 percentage points a year over the forecast period. That is a loss to economic output which accumulates “by roughly an additional £4 billion every year, making fiscal consolidation even more difficult”!

Box 3: The Economist February 19th -25th 2011 page 31

For many years the job of the Bank of England's MPC seemed straight forward. The knocks that from time to time pushes the economy off its path of steady growth – in Ghana the 'trend path' with an estimated annual growth rate currently placed at 7 percent – tended to shore inflation too. A weaker economy meant interest rate cuts; recoveries prompted rate rises. The bank's rate – setters knew it might not always be easy – that in some instances, output and inflation might be pulled in opposite directions. But they might never have envisaged a policy dilemma quite as acute as they now face.

Much of today's inflation stems from temporary influences beyond the BOG's control: a surge in energy and food prices and delayed effect of a weaker currency. These are likely to fade – unless firms and employees start to factor high inflation expectations into their price and wage setting. An increase in interest rate might lower the chances of that spiral. But it might also unduly harm the economy.

What makes the bank's problem especially difficult is that the IT is still young and the BOG has hardly established its credentials as an inflation fighter. Some may argue that modest tightening might do little harm. They mean by that the policy rate is “ too low” to have much influence on the much high lending rate of the commercial banks on business loans especially to SMEs as well as for mortgages. But this cannot be taken for granted. The opposite may well be true! For his part, Mervyn King scorns the idea that a policy rate increase will make little difference, but is necessary all the same. Better to explain carefully why high inflation is likely to prove temporary than to indulge in “futile gestures”

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