Indexation a Short-run Answer to Inflation

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THIS pamphlet* deals with the problem of monetary correction through indexation, though only in the absence of any political will by governments to abolish inflation by restricting the money supply. The author, therefore, repeatedly emphasizes that he is not arguing that this is the best method to prevent inflation, it is simply the only politically acceptable one in present circumstances. He does, however, believe that indexation has certain practical advantages in its modes of operation which will ultimately create a political will to stabilize money-value.

The most fascinating part of the work is undoubtedly Friedman's devastating analysis of governmental dishonesty in using inflation as a hidden tax. But as a monetarist, he tells us that whereas short-run changes in prices, whether particular or general, can have many causes, "long-continued (and I would have added across-the-board) inflation is always and everywhere a monetary phenomenon that arises from a more rapid expansion in the quantity of money than in total output." He then proceeds to point out that the advantages accruing to governments from increasing the money supply are many and various, although the main one is that it amounts in all essentials to "taxation without representation".

Even so, in the present age, inflation has had other stimulants as well as the basic one of extracting money from the taxpayer through *implicit* rather than *explicit* taxes; among these are attempts to maintain fixed exchange rates (now mercifully abandoned!) and, more important, a commitment to full employment. Likewise, Professor Friedman reminds us that the revenues of governments from inflation are also particularly attractive, since the printing of paper money not only allows the painless financing of expenditure, it also swells in paper terms the size of profits and permits the levying — through fiscal drag — of disproportionate taxes on all returns to industry and thrift. Savings, especially national savings, are in this regard a gold-mine for a government in times of inflation, because their real value constantly declines to the latter's benefit; so much so in recent years that the author expresses moral indignation and declares that "the savings bond campaigns of the US and UK Treasuries have been the largest bucket-shop operations ever engaged in".

Not surprisingly, it is at this point that he introduces his qualified prescription for reform, which is essentially a somewhat less painful anti-inflation strategy than the full-blooded monetarist one. His prescription, as previously stated, is indexation, and Friedman uses an agreement drawn up by General Motors with its workers as an illustration of what he proposes. The agreement, in fact, failed because indexation was not introduced into it, and the conclusion he draws from this example is that if indexation had been accepted it would have prevented industrial strife. With regard to the criticism that indexation itself causes inflation, on the other hand, he shows virtually by definition that this cannot be the case, since it is merely a topping-up process after inflation has taken place and thus can never be its initial stimulus. Yet here again he acknowledges that the device is only second best, to be used sparingly in the absence of a political will to practise more radical solutions.

If we are to criticize this pamphlet in any way, it is certainly not because of the practical proposals it contains, but rather because of a certain imprecision in its formulation of monetary theory. Despite a recent television programme in which Professor Friedman berated his British colleagues for their inability to distinguish between money and credit, he seems to have fallen at times into the same trap himself. Hence he states that "fiat money serves as a base on which the banking system creates additional money in the form of bank deposits". But, in fact, only national banks normally create money and all other banks create credit. Credit, however, is not inflationary unless an equal amount of specie is created to cover it, because for every creditor there is an equal and opposite debtor to cancel each credit out. The increasing of credit can consequently have no influence on money-values whatsoever as long as governments forgo resorting to the printing press.

Again, the above-quoted definition of inflation as a more rapid expansion of the money supply than increases in productivity, is inadequate even from Friedman's own point of view, since it appears to concede that it is legitimate to inflate to mop up the natural increase in productivity, provided that the object is to keep monetary values steady. But what is this if not another hidden tax! Surely it is morally far better to split money up into smaller, more convenient denominations from time to time while retaining its overall value rather than to inflate in step with every increment of growth? These occasional theoretical lapses, however, do not in any way detract from the force of Friedman's ingenious prescription for taking the sting out of monetary disinflation in present circumstances, and his plan for indexation can be wholeheartedly endorsed. But because of a certain fluidity in his definitions, his pamphlet may be construed as conceding slightly more from a monetary standpoint than its author seems to intend.

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* *Monetary Correction, a proposal for escalator clauses to reduce the costs of ending inflation*, by Milton Friedman, published by the Institute of Economic Affairs, 1974.