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Remedy for Inflation: The conundrum for Governments

The world is suffering from the side effects of soaring inflation. Each country is trying to find solutions to tackle these problems, either sometimes by referring to an economics manual, or at other times by repeating past practices; sometimes by combining the two.

Few countries, on the other hand, resort to "heterodox" solutions that exist neither in theory nor in practice.

While the theories and policies rationalised by economics handbooks based on practical experiences are generally accepted as "orthodox", I do not find it appropriate to describe practices other than these as "heterodox".

Not every "unorthodox" practice is heterodox, and economics literature cannot be changed by insisting on utilising unusable practices.

Therefore, the goal of economic policies should be to generate benefits, and the benefits they generate should be aimed at improving society.

Some would benefit from the side effects of a wrong practice, but it would not be right to pass off such a practice as "policy".

The generally accepted method for fighting inflation is either to raise interest rates or to reduce money in circulation, or to apply both simultaneously.

> There is no guarantee that hiking rates will help eliminate the inflationary environment we live in

"Abundant money, high interest" can be an interesting experiment under certain conditions. However, its side effects would be too many to count.

"Little money, low interest", on the other hand, is self-contradictory, unlikely to be a goal that even policy makers would deliberately want to achieve. It may a conjunctural policy but it would only be a temporary solution.

Keeping the policy rates low, instructing the regulatory authorities and central bank to force financial institutions to lend money below market rates and trying to curb demand by limiting the money supply are irrational practices.

Such actions would be seen as nothing but an attempt to break the existing correlation between inflation, interest rate and market realities.

Although it may seem like it works in the short run, it will unavoidably lead to uncertainty, distrust, and further disruption in pricing behaviour. The result would be higher, and sticky, inflation.

The truth is there is no guarantee that hiking rates will help eliminate the inflationary environment we live in.

We will not be able to avoid facing higher and higher inflation rates because of the supply chain restructuring after the COVID-19 pandemic and fluctuations in commodity prices triggered by the outbreak of Russia-Ukraine war.

If Turkey raises interest rates sharply and rapidly out of fear of inflation, it will inevitably suffer from two major problems at the same time: recession and high inflation. As you may recall, I have repeatedly mentioned such a potential risk in my previous articles.

> European governments tend to make price rises a priority, not the GDP growth

In a recent article, I explained the difference between the American and the European perspective on inflation:

“... the European Central Bank will continue to sharply raise its policy rates so as to be able to fight inflation, which has been a major problem throughout European economic history, and that’s why the European governments tend to make price rises a priority, not the GDP growth.

The Roman Empire faced a very long inflationary period during which no money was left in the treasury, so soldiers in the Roman army were paid with salt instead of coins.

Originating from the Latin word for salt, sal, or salis, the etymological root of the word salary dates back to Roman times, a memory left behind by the economic difficulties of the time.

Europe also suffered from conjunctural inflation waves, caused by the Latin American gold brought in the continent by the Spanish and Portuguese explorers.

However, the most severe inflation in recent history devastated Germany. Hitler's coming to power and becoming a dictator immediately afterwards as a result of the hyperinflation that astronomically devalued German currency has been one of the most tragic events in the European history.

We could find many other events in history which cause Europeans to be wary of inflation. So, it's not hard to guess that they will behave differently than Americans who are more afraid of a recession..."

> It is not possible for emerging markets struggling with high inflation to solve the problem merely by hiking interest rates

While bearing in mind that the Fed and the ECB act cautiously, even though they think differently about interest rate hikes, I must say that it is not possible for emerging markets struggling with high inflation to solve the problem merely by hiking interest rates.

However, this does not mean that the implementation of interest rates should be dictated in a way that ignores market realities.

On the contrary, we need an interest rate that will persuade citizens to believe that their savings will not lose their value and to stop stockpiling goods and services with an attempt to protect themselves from inflation.

However, these changes alone would not be enough. Emerging markets also need to enact structural reforms to maintain the value of their national currency given the dollarized lifestyle in their countries.

Of course, these reforms are disliked by the governments because these reforms require them to provide justice, liberties and education not according to their own standards, but according to universal ones.

For this reason, they tend to use shortcuts to control exchange rates. However, there is another fact they forget:

The Persistence of Attempting the Impossible

If capital movements and monetary policy are not under strict check in a country, trying to keep exchange rates fixed leads to chaos.

When it is understood that the forced concept known as the impossible trinity or the impossible trilemma, which states that it is not possible to have a fixed foreign exchange rate, free capital movement and an independent monetary policy at the same time, will not yield any results, then governments will seek ways to control them all.

Because each previous practice creates negative side effects on one or more of the macroeconomic parameters every day, such as: imports increase, current account deficit grows, and finally, inflation rises again as exchange rates go up. I can list many other side effects.

That being said, I once again remember the most important experience in my past managerial positions: in a business environment where problems occur every day, executives eventually give up on the natural flow of things and switch to a centrally controlled system.

In such case, the market rules or the market order no longer apply. It may be possible to adapt to the markets for a while, but markets are "markets", as the name implies.

In the universe of markets, anything that becomes a stranger to its own essence will not be remembered as its original self.

This chaos would eventually cause the emergence of certain individuals or groups that slyly monitor the responses to daily crises and try to derive personal gain from them.

As the burden on both the government’s and people’s shoulders become heavier, unjust enrichment or acquisition increases. It is hard to believe that any government, unless it has ill intentions, acts according to a hidden agenda to serve such a purpose.

> If the practices of the decision makers do not create the intended benefits for society, but serve to the advantage of certain people or groups, such practices should not be defined as part of an economic policy

In conclusion, if the practices of the decision makers do not create the intended benefits for society, but serve to the advantage of certain people or groups, such practices should not be defined as part of an economic policy.

There is nothing wrong with being revolutionary and regarding the inflation-fighting practices that have proven useful and fruitful as "outdated" and trying to replace them with new and effective methods.

However, it should not be forgotten that science says that big claims require big evidence.

I also admit that science puts many different events in the same pot to create a "general opinion", sometimes by forcefully establishing a correlation between them.

However, those who say that they have found a better treatment for a disease than those that are already capable of healing the patient should not be hasty.

Before employing a new treatment method, it is necessary to withdraw the life-sustaining measures and see whether the patient can survive. For now, it seems best to find a cure by making partial changes to regular prescriptions and treatments

Dr Emre Alkin is one of the most influential economists in the world. He is the President of Topkapi University in Istanbul, and well known author of the 4 best selling novels and 14 in total about socio-economics in Turkish and English. He held various positions in GSM and Telecommunication, International Financial İnstitutions, Payment Systems, Energy, Iron-Steel Industry and Insurance. Prof. Alkin participates in international projects about payment systems and financial management.