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INFLATION IN BELIZE

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## INFLATION IN BELIZE

Inflation is difficult to define in precise, scientific terms and it is even more difficult to explain its mechanism. Indeed, as of today there does not exist one generally-accepted definition for inflation, nor one generally-accepted theory.

Historically, each inflation, or episode of inflation, exhibits complex features of its own: it can occur in varying degrees of intensity, from very mild (creeping inflation) to very acute (hyper-inflation); it can be self-terminating, intermittent or self-accelerating; it may appear to be caused by excess demand (demand-pull inflation) or by cost increase (cost-push inflation) etc.

For the above reasons we shall not try to give another definition of inflation, nor support any of the existing ones as being the definition of inflation. However, as we need to characterize the phenomenon in order to deal with the subject, we shall define inflation rather loosely as a condition of a rising price level. We realize that this definition is not satisfactory because it automatically classifies as inflation any condition of rising prices, irrespective of both the rate of increase and its origin or causes, and as non-inflation any condition of stability in the general level of prices, no matter how it has been achieved.

Belize exhibits similar economic characteristics of a small, open, developing country. Indeed its economy may be categorized as a "dependent monetary economy" because of the structure and performance of its monetary and financial institutions.

An analysis of the economy shows a small population with large land endowment (skewed resource base) heavy specialization on the

production of primary commodities for sale in overseas markets, high import coefficient, lagging domestic production and high rates of foreign trade to GDP. The economy also suffers, inter alia, from the automaticity of the financial system, diseconomy in administration, weak budgetary position, and high dependence on foreign capital.

Given this type of economic structure of internal price levels, demand and output and employment are critically dependent on external forces. In this situation, the number of anti-inflationary measures which can be effectively used is limited.

Among these measures are a price and incomes policy, some degree of control over the banking and financial system to enable Government to pursue an active monetary policy and fiscal policies geared to increase agricultural production and to reduce dependence on imported goods.

#### *Types of Inflation*

The structure and nature of the Belizean economy makes the identification of the specific type of inflation being experienced very difficult. The different types of inflation, i.e. demand inflation, and supply inflation - mark-up inflation, can only be differentiated academically. One sees the characteristics of each type of inflation present and the dearth of meaningful statistics prevents one from being able to diagnose the particular inflation. At most one can say that because of its structural characteristics, Belize is experiencing a hybrid type of inflation.

Our Ministry of Economic Planning is only now working on the production of national income statistics, a price index and other related

statistical data. As such the movement of prices can only be made by value judgement. It is not unreasonable to assume price increases in the range of 25 - 35% annually over the last two years.

#### *Consequences of Inflation*

Among the factors determining the progress of inflation are the strength and militancy of the labour unions; the level of unemployment, the extent of excess capacity, the strength and commitment of the government to full employment or welfare policies, the nature of economic and financial policies; the expectations of the community regarding changes in the standard of living; future price trends; the marginal propensities to import and to consume; the duration of lags in normal economic sequence; the size of the foreign exchange reserves which can absorb some of the inflationary impact, the availability of foreign credits. The combination of all or some of these forces will lead to continuing real changes in the economy which may become increasingly pathological, and which may, in the end, even prevent the economy from maintaining its operations at full employment or full capacity level.

#### *Role of Monetary System*

The monetary environment is an important determinant of the progress of an inflation. While inflation can arise in many ways, a continuous rise in prices could not occur unless some measures are found to finance the increased monetary value of transactions at the higher level of prices and costs.

The relative price structure is changed in such a way as to cause

an allocation of resources materially different from the one envisaged by government. Additional uncertainties complicate the process of formulating decisions on the part of households, businesses and governments. Norms expectations and economic behaviour undergo changes which are often unpredictable. As a result, the basic macroeconomic functional relationships are altered with consequent implications for the working of the entire economic system. For these reasons, even when the economy is "apparently" booming in an inflation, there is reason to doubt the productive character of the investments and the soundness of the pattern of growth taken place under these conditions.

Consumption, especially of non-essential items, is encouraged and savings, in the form of financial assets, is discouraged. Shifts are produced in the pattern of investment. Investment is diverted from the long-range production types of high yield and speculative ones. The budgetary position tends to deteriorate. These factors militate against some of the objectives of the country viz to restrain the rise in consumption, to mobilize the maximum amount of domestic saving and to ensure that investments are made in socially productive projects.

The external payments position suffers deterioration as a result of stagnant or declining exports and rising imports. In this case, unusual high prices for our exports have narrowed our deficit. The deterioration of the external payments position is accentuated by adverse movements in the capital account of the balance of payments, with a reduction in the capital inflow. Some countries may experience relatively high rates of growth under the stimulus of inflationary policies for a certain period, but the duration of such growth would be limited by the availability of

foreign exchange reserves. The persistence of strong inflation would lead to balance of payments problems, which would limit the freedom of action of the country and unfavorably affect the development effort. In such a situation corrective measures must be pursued. At an advanced stage of the inflationary process, such measures are bound to have an initially depressing effect on the level of investment and economic activity, in view of the magnitude of the adjustments needed, the degree of distortions already existing, and the need to reconstitute the depleted foreign exchange reserves.

It is not possible to make an equally categorical assertion about the effect of mild or moderate inflation on economic development. It can be argued that gentle rising levels of prices, wages and other incomes might contribute to the flexibility of an economy and ease the process of transition experienced by a country in the course of rapid development. With development, some types of output would experience only slightly increased demand, so that they decline in relative importance, while other (presumably) more socially desirable types of output would experience a much more rapid increase in demand while rising living standards.

These socially desirable types of output would then become relatively highly priced and produce higher incomes in the economy and their production would be encouraged. Producers of such goods might then bid resources away from other units, which would raise the general level of prices and costs in the economy, even though the prices and costs of the non-expanding activities would not rise and might even decline somewhat.

*Effect on Price Structure*

Because of the structure of the economy, it is difficult for Government to fight the causes of inflation though it attempts to minimize its effects. In this situation, the value judgment of the government is increasingly substituted for the verdict of the price mechanism. The consequences of inflation are being fought by the establishment of a growing system of economic constraints, including price regulations, rules about production and marketing. These measures impose a heavy administrative burden, requiring controls, supervision sanctions and similar measures.

*Effect on Income Distribution*

Complete assessment of the re-distribution effect of inflation requires consideration of its differential impact on individuals and groups.

For many years it was believed that, in an inflation money wages tend to lag behind prices; consequently real wages would fall and real profits rise. This view has been challenged in recent years and the statistical evidence adduced in favour of it has been found to be shaky. One factor may be the different re-distributive effects of cost push and demand-pull inflation. To the extent that the distinction between the two types of inflation is valid, one would expect, other things being equal, to find wages rising faster than profits in the former and losing out to profits in the latter.

It can, however, explicitly be stated that, in an inflation, the "active" elements (wages and profits) gain relative to the "passive" elements (rent, interest and dividends). The major losers from inflation are the relatively fixed income groups, such as pensioners social security

and insurance recipients, bondholders etc. Also studies have demonstrated that, as an alternative to taxation, inflation is a more regressive form of tax, especially from the lower income groups, than either income or sales tax.

As for the relative shares of wages and profits, it is generally agreed that, in the early stages of a mild demand-pull inflation, there may be a shift from wage earners to profit receivers. But, with the persistence of inflation, wage-earners are certain to become aware of their loss of real income and will press for higher wages and escalator clauses. (Also true of government employees). At the same time, employers, with rising money profits, will be willing to compete for workers by agreeing to higher wages. The net result would depend on the extent of pre-existing unemployment and the relative strength of the unions.

#### *Effect on Private Consumption and Saving*

Rising money incomes and consumption expenditures are associated with the inflationary process. The rise in consumption would not prejudice the development effort of consumption did not rise in real terms and if the functional relationship of consumption to income was maintained unchanged. However, there are forces at work in an inflation which tend to change the consumption schedule and the propensity to consume. In this process the role of expectations is crucial.

If inflation is mild and there are no expectations of an acceleration of the rate of inflation, the consumption function may not shift upwards because spenders are subject to "money illusion" and plan their purchases in money terms. But if strong inflation has persisted or is anticipated,



expectations of sharp price rises in the future would increase the marginal propensity to consume, because present consumption would become more desirable in view of the expected depreciation in money value.

The re-distributive effect of inflation introduces further complications. If there has been a shift in income from wage earners to profit receivers as in the early stages of a demand-pull inflation there would actually be a tendency for a downward shift in the consumption schedule because the profit receivers would presumably have a lower propensity to consume than the wage earners. Even in this case, it is possible that expectations of further price increases may have raised the marginal propensity to consume of the profit receivers. Moreover, this phase is likely to prove temporary; as inflation gathers momentum, wages are likely to rise after a certain lag. In a wage-push inflation, there may be a shift in income from profit receivers to wage earners, and this is likely to raise the consumption schedule upwards. In sum, the stronger and more persistent the inflation, the stronger is the likelihood of an increase in the marginal propensity to consume i.e. of an upward shift in the consumption schedule.

Apart from changes in aggregate consumption, inflation is likely to produce changes in the pattern of consumption. There is likely to be an increase demand for luxury goods and items of ostentatious consumption. This follows from the windfall profits and other re-distributive effects of inflation.

The converse of what has been said about consumption is true of the behaviour of savings in an inflation. One of the characteristics of inflation is a growing distrust of money. While the decline in the real

value of money savings held in bank deposits, insurance policies, social security funds, government securities or similar forms, the confidence of the public in these financial assets (whose value is fixed in money terms) is weakened and the entire financial structure of the economy begins to behave in abnormal ways. There is statistical evidence that, in recent years, the ratio of money to income has declined in countries where inflation has prevailed and that countries which have experienced strong inflation over extended periods, the volume of savings accumulated in the form of financial claims and assets has been quite small, compared with substantial accumulation of such savings in more stable countries.

As in the case of consumption, inflation is likely to produce variations in the pattern of personal savings in addition to the effect on the aggregate volume of saving. Saving in the form of money and quasi-money accumulation represents the most widely accessible form of saving, especially in countries without highly developed money and capital markets. For the vast majority of the people in these countries, there are relatively few other ways (except hoarding) in which they can hold savings. Individuals, who reduce their money savings as a result of inflation will undoubtedly divert some of the reduction to increased consumption and to other forms of saving which may not be easily available to finance "productive" investment. The saving thus diverted may find outlets such as foreign exchange, precious metals, jewelry, and objects, real estate and other "hedges" against inflation. The general shift away from financial markets, the orderly growth of which is vital to promote sustained economic development of the poorer countries.

The distortion of the pattern of liquidity preference exerts a similar depressive effect on business saving, which will be under pressure to distribute, rather than reinvest, current earnings.

*Effect on Private Domestic Investment*

It is possible to make more positive assertions about the effect of inflation on the pattern of investment than on its aggregate volume. In a mild inflation, or in the early stages of a strong inflation, it is probable that optimistic operations prevail about the business outlook and that they serve to raise the level of investment. In different terms, this means that the acceleration principle is operative. It does not, of course, follow that the increase investment would necessarily be of the "productive" variety. With the persistence of strong inflation, the expectations are likely to change towards pessimism in view of the increase uncertainties, the social conflicts, the unstable economic situation and balance of payments problems.

Inflation encourages speculative investment in inventories, in land, in luxury housing etc. as a hedge against inflation. Similarly, inflation would encourage investment in the domestic production of luxury goods whose prices are not controlled and whose import may have been restricted (through high duties) quantitative controls or exchange depreciation.

Another impact on investment will occur when inflation leads to "paper profits" which are then distributed or taxed away to a considerable extent. If business firms continue to make their calculations in the basis of historical costs, or if government tax regulations define profits in that manner, business firms, while apparently making considerable book profits, may be eating into their capital.

In general, inflation would discourage genuine "risk" investment which involve innovation and which would contribute the most to long-run

growth. Inflation would encourage investments with a relatively short "gestation" period which can be amortized fairly quickly (i.e. with high profits). More traditional forms of investment would be more risky, because the added uncertainties of inflation would render incalculable the potential costs and benefits of the "innovating" investments.

#### Effects on Government Finance

Tax revenues bear a functional relationship to national income (assuming tax rates to be unchanged), while government expenditure are determined by forces outside the macroeconomic system. The effect of inflation would be to increase both government revenue and expenditures in money terms. The net impact of inflation especially in a strong one, would be to increase government expenditures faster than revenues, increasing the size of the budgetary deficit which might have triggered the inflationary process in the first place. An increase in the budgetary deficit would worsen the inflationary situation, via the multiplier process and the consequent rise in money income.

Considering the effect of inflation on tax revenue first we can safely state that tax revenues would increase with the inflationary increase in money terms, the size of the increase depending on the marginal tax burden.

The analysis of the effect of inflation on government expenditure will tend to rise in line with price increases because of the desire of governments to maintain the real value of their expenditures. The pressure from groups adversely affected by inflation often lead to an increase in government expenditures, in order to restore, at least partially, the

relative income position of such groups. Thus, while receipts in money terms rise in an inflation, current government expenditures normally rise more promptly as a result of the following factors directly attributable to the inflation -

- (i) Salary increases for government personnel and increases in pensions and social welfare benefits, granted for reasons of equity or in response to pressures.
- (ii) For reasons of social welfare governments often adopt expedients such as price controls or subsidies.
- (iii) A substantial part of the rise in government expenditures is due to the direct price effect of the inflation, for example, the increased cost of materials purchased for government use. In the event of exchange depreciation, high payments have to be made for imported materials, external debt service.

In many developing countries, inflation originates from the effort to push public investment beyond the limit of available domestic savings and net foreign loans and grants; paradoxically enough, a reduction in real public investment is frequently the result of a prolonged inflation.

This unwanted consequences comes about largely as a result of increases in current government expenditures. Government is faced with a real dilemma. If real public investment expenditures are reduced, the rate of development will obviously suffer; if on the other hand, the government decides to maintain the real value of these expenditures even in the face of increasing current expenditures, the result will frequently be an increased budgetary deficit which will aggravate the inflationary situation.

*Effect In International Payments Position*

Countries suffering from strong sustained inflation are apt to run into serious balance of payment problems. The extent of the external payments deterioration depends on the intensity of the rate of inflation in a given country compared with that prevailing in countries with which that country maintains close economic relations. In general developing countries have closer economic ties with the advanced industrial countries, which are their principal trading partners as well as their source of capital, than with other developing countries. Also in general the rate of inflation in the developing countries has substantially exceeded in the advanced industrial nations.

The Less Developed Countries are likely to feel the adverse impact on their external economic position more severely than the advanced countries for a variety of reasons. Their economies are not broad-based, and with the existing rigidities in their economic structure and the limitations on their productive potential, it is very difficult for them to respond flexibly to a deterioration in their payments position and to make the necessary adjustments. These countries are, in general, dependent on foreign trade for a wide range of consumption and investment goods, and foreign trade bears a higher ratio to their national income than in many advanced countries. In view of the low level of domestic savings, a significant proportion of their development programs is financed through export earnings and net foreign loans and grants. Therefore, any thing that disrupts the international trade mechanism is bound to retard the development process, and inflation does reduce the export capability, increase the propensity to import and curtail the net capital flow.

One of the major problems facing the economy at least in the short run, is the need to reduce the current high rate of inflation and to dampen its effects. There are policy mechanisms for dealing with high prices but such policies generally lead to a further deterioration in output. And there are measures for expanding demand and increasing output, but these measures are generally associated with rising prices. This is the dilemma.

As regards a prices and incomes policy, we should recognize that it is not possible to insulate Belize fully from rising external prices which make the greatest contribution to domestic price inflation. We must continue to import essential capital goods to the extent that such goods will be fully and efficiently utilised, raw materials for our industries and other essential items which we do not produce. It is Government's intention, however, to continue to pursue an active price control programme aimed at ensuring that necessary price increases are kept to an absolute minimum. This will be done by closely regulating margins at the wholesale and retail levels. Care will be taken to ensure that the margins allowed are realistic and are kept under regular review as the Government recognizes that the private sector must be allowed to make reasonable profits in order to expand enterprises and provide further employment. Every encouragement will continue to be given to genuine investors to establish industries in Belize

Efforts to attract further funds for our DFC for industrial and agricultural projects will be continued.

In the present difficult period of inflationary pressures and shortages, we clearly must move vigorously to increase agricultural production and reduce our dependence on imported supplies to the maximum extent economically

feasible. We must encourage consumers to shift to locally produced goods. This all calls for strong support of local agriculture and domestic manufacturers who are producing goods of acceptable quality. We do expect those industries that are given generous protection and tax concessions to produce acceptable quality goods and reasonable prices. I realize that a shift to locally produced goods, while safeguarding supplies, may not initially result in lower prices to the consumers, but buying local should in itself tend to generate additional positive benefits for the people of our country, as local incomes should rise. I realize too that the prices of our own home produced goods have in many cases increased considerably, partially due to a high import content in some locally produced goods, to shortages or scarcities and from efforts by producers to maintain their ability to purchase other goods and pay for necessary services. Increased agricultural output should, however, by sheer plenty, operate to bring down in due course the price of locally produced goods, while increasing the gross income to farmers.

With regards to imported commodities we are relying on our importers to seek out new sources of supply in order to ensure that the consumer pays the lowest price, notwithstanding the possible difficulties inherent in switching from a regular source of supply.

This brings me to the question of the relationship or inter-action between the movement of incomes and prices. One of the main objectives of economic development, as I understand it, is to increase real incomes and improve the distribution of an increasing real national product in the country. I need not tell you that money incomes have increased rapidly over the last ten years or so particularly in the private sector.



In the difficult wage/price spiral which we are experiencing, it seems necessary for some arrangement to be worked out which will ensure that those hardest hit by inflation should be helped first, such as pensioners and others living on fixed incomes and the lower income groups. This will require some restraint among wage and salary earners, particularly the high income groups, as well as the owners of capital, the recipients of dividends and rents etc.

While it is tempting to press for incomes to be tied automatically to consumer price movements, we should realize that automatic wage adjustment in a situation where prices are already tending upwards is in itself highly inflationary. Wages would tend to chase prices, and prices would in turn tend to chase wages with the inevitable result of a vicious inflationary spiral. We must also not overlook the position of the unemployed who has no income to adjust, the wide disparities in productivity in different sectors, the need to improve the relative position of the low income groups and the fact that the price increases derive in many cases mainly from imported inflation. In all the circumstances the Government is inclined to favour a system of wage adjustment based on periodic reviews of wages and salaries both for the public and private sectors which will take account of productivity and rising prices.

These are all very complex issues which require careful consideration before a final decision is taken on any prices and incomes policy.

The Monetary Authority to be set up will be able to assist in limiting the imports of unnecessary consumer goods, both for balance of payments reasons and in order to channel resources into more productive activities. The Authority will also be able to influence the structure and level of interest

rates. Considerable liquidity has developed in the banking system, and it seems right now for the banks to move to an early reduction in the very high rates of interest being charged on loans so as to provide every possible stimulus to expansion of the productive sector of the economy. Some controls over consumers credit by regulating the amount of deposit and terms of payment would also be necessary. The regular issue of Government debentures, an attractive national savings scheme and reserve requirements on the banks are all measures which could make a contribution to reducing inflation.

As regards fiscal policies, these should aim at increasing local production and curbing imports.