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Recession and Inflation: 1981

The justification given by the neoclassical economists for the fiscal and monetary policies of controlling inflation is that a reduction in demand tends to reduce prices. This assertion can be found in any traditional textbook and is accepted by most people as an obvious truth. Nevertheless, there is nothing further from the truth than the traditional neoclassical theory of prices.

Actually, it forms a very important ideological justification, and it will continue to appear in the traditional textbooks for a long time for this reason. In this chapter, we intend to show that the monetarist economic policy implemented in late 1980, which tried to control inflation by a recession, actually accelerated it, especially in the oligopolized sectors of the economy.

By analyzing the price indices collected by the Getúlio Vargas Foundation, we can verify that the oligopolized sector of the Brazilian economy showed an acceleration in inflation during the same period in which demand underwent a very strong retraction. The fact that the annualized inflation rate verified in the May-June-July 1981 quarter in the oligopolized sectors was extremely high was a reflection of the monetarist policy. In the oligopolized sectors such as beverages this rate reached 343.5 percent, for the tobacco industry 301.0 percent, for electric materials 224.7 percent, transport material 162.9 percent, etc. At the same time, the more competitive sectors of industry, as well as the agricultural sectors and the producers of raw materials, showed much lower rates: lumber 11.32 percent, the metal industry 35.04 percent, textiles, apparel, and shoes 57.91 percent, food products 64.32 percent, agricultural products 40.38 percent, etc.

Thus the modest deceleration of inflation that occurred in 1981 was

due to the fall in the rate of increase of the prices for agricultural products, raw materials, and the more competitive industrial sectors. Although output had fallen 9.6 percent in the manufacturing industry in the period from January to November 1981, compared to the same period for 1980, the wholesale price index for this sector showed a modest fall (100.3 percent in 1981 compared to 109.0 percent in 1980). In other words, the results obtained by the monetarist policy implemented since November 1980 were negligible and could be temporary. All that is needed for the inflation index to return to practically the same level as that of the previous year is for the prices of agricultural products, which increased only 70 percent in 1981, to adjust themselves to the same level as industrial prices (Table 7.1).

1

The most obvious thing for us to do in order to understand inflation is pay attention to the mechanism of the formation of prices. The traditional neoclassical economic theory put forth in textbooks does not clear up anything as long as it assumes that the exchange activities of abstract individuals ("producers") determine prices. On the contrary, the modern capitalist economy is dominated by big corporations that are multidivisional and monopolistic, and this institutional characteristic must be incorporated into any theory of prices. These corporations are made up of units of capital with a complex administrative structure. Actually, they are social agents dedicated to the valorization of capital, and it is in these terms that prices are determined. On top of this, the process of concentration, which is inherent in the capitalist system, permits the creation of barriers to the mobility of capital. Each corporation has a determined degree of monopoly, that is, the possibility of obtaining monopolistic profit rates. In most industrial sectors, big oligopolies dominate, and they administer their prices in the market independently of the conditions of supply and demand.

Given these conditions, it is not difficult to understand why the prices of the oligopolized sectors present behavior contrary to the neoclassical dogma, accepted as an obvious truth, that a reduction in demand provokes a reduction in prices. In practice, each oligopolistic corporation has its target profit rate, determined by its degree of monopoly. In order to reach this rate, it fixes a profit margin that, when added on to direct costs, will establish a price capable of covering the overhead costs, in addition to its target profits. Once this profit margin is calculated, it tends to remain

Table 7.1 Trends of the Inflation Rate (Annual Rates)

	12 Months from December 1980	12 Months up to December 1980	12 Months up to July 1981	6 Months up to July 1981	3 Months up to July 1981
General Price Index	108.55	95.2	110.50	105.06	84.69
Cost of Living Index	86.34	100.5	108.45	107.20	102.02
Cost of Construction Index	112.99	86.2	96.20	92.19	36.07
Wholesale Price Index	118.62	90.5	108.17	97.73	80.87
Agricultural Products	138.17	70.7	105.22	74.21	40.38
Industrial Products	110.26	99.7	108.82	108.57	101.74

Source: Conjuntura econômica; Getúlio Vargas Foundation

Table 7.2 Wholesale Price Index (IPA) – Manufacturing 1981

1. Competitive sectors that show a clear inflationary deceleration					
	12 months from December 1980	12 months up to December 1980	12 months up to July 1981	6 months up to July 1981	3 months up to July 1981
Metalurgy	102.40	83.2	79.91	64.96	35.04
Lumber	157.50	21.6	65.66	26.08	11.34
Real Estate	121.42	81.8	108.01	61.83	86.52
Leather and furs	43.97	89.1	·73.61	90.82	61.02
Textiles, clothes and shoes	101.84	68.8	76.24	56.17	57.91
Food products	85.60	96.9	92.03	80.17	64.32

2. Oligopolized sectors that showed acceleration and/or hight inflationary rates

	12 months from December 1980	12 months up to December 1980	12 months up to July 1981	6 months up to July 1981	3 months up to July 1981
Electrical material	106.62	135.2	129.70	178.19	224.73
Home appliances	115.13	134.0	137.34	191.65	227.27
Transport material	107.38	149.4	149.85	183.14	162.94
Motor vehicles	107.53	148.0	146.72	176.22	157.65
Paper & cardboard	95.87	120.5	110.53	102.06	157.85
Rubber	136.29	166.5	140.29	146.77	158.99
Chemicals	130.72	113.9	130.84	163.87	149.25
Beverages	118.71	127.2	141.85	127.01	343.51
Tobacco	65.39	183.0	156.28	287.73	301.00

Source: *Conjuntura Econômica;* Getúlio Vargas Foundation

relatively constant. Under normal conditions, prices are determined by adding the fixed margin to direct costs, which is why they tend to be insensitive to variations in demand. In the meantime, any variation in direct costs tends to be passed on to prices.

However, when demand falls drastically, as happened in the first semester of 1981, fixed unit costs increase, and if the profit margin does not increase, profits will be eaten away by this increase in costs. As oligopolistic corporations have control over the market, they try to recover the losses suffered from the fall in sales by increasing their profit margins. By increasing the profit margin for the remaining sales, they try to assure their projected profit rate.

This is exactly what happened in the 1981 recession. The Brazilian economy entered a process of recession after extremely restrictive monetary measures were applied beginning in the second semester of 1980. As a result, the oligopolistic sectors raised their profit margins, provoking a typical inflation of profits. It was precisely during the period of May-July 1981 when the corporations made the greatest cuts in the level of their production, laying off many workers, so that their profit margins and their prices underwent the greatest increases, as can be seen in Table 7.2. Once the margins are raised, if there is no fall in demand, there is no reason for the oligopolies to precipitate changes in prices. This explains why, in the following months when demand fell less rapidly, the rate of inflation was smaller.

2

Aside from these concentrated and oligopolized sectors, there is also a segment of the economy made up of the agricultural sector, the sector that produces raw materials, and some competitive branches of industry in which the mechanism for establishing prices is very different from that in the oligopolized sector. There is a free mobility of capital in these sectors, and thus firms do not have the power to administer their prices. Intercapitalist competition makes prices relatively flexible. When there is a drop in demand, they react by reducing their prices in order to be able to honor their financial commitments. This is clearly seen in Table 7.2, where we can verify that these competitive sectors decelerated their prices when demand underwent an accentuated fall.

However, this deceleration has its limits, because when prices cease to cover direct costs, all corporations prefer to stop production. Thus, once a level of prices is reached in which there is no profit, even the competitive corporations begin to pass the increase in their direct costs on to their

prices. The recessive policy then stops working in an anti-inflationary way in these sectors.

In this way, what happens to inflation depends on the relative weight of the competitive and oligopolistic sectors in the economy. If the relative weight of the concentrated sectors is very great, the recession tends to accelerate inflation by compensating for the falls in the competitive sectors.

3

Obviously, this process of increasing profit margins has its limits. We then need to know what these limits are and when they begin to act. They depend on the degree of monopoly, that is, on the capacity of the corporations to set up obstacles to competition, such as imposing barriers for new corporations entering the sector, differentiating products, controlling technology and channels of distribution, etc. The greater their degree of monopoly, the longer the recession must last before the oligopolies no longer respond by increasing their profit margins. However, there is a moment in which this policy of raising prices no longer compensates for the fall in sales, and all of the corporations go into the red. This happens when the recession turns into a depression that is so prolonged that it destroys the whole economy, provoking generalized bankruptcy. Prices (relative to wages) also go up so much that demand becomes extremely sensitive to new increases. At this point, the unemployment level is so high that wages have already undergone big reductions and inflation thus begins to yield. In this case, the monetarist policy does have some effectiveness, but it is at the cost of a large increase in unemployment and a reduction in real wages.

A effective reduction in the inflation rate takes place especially in the next phase, when demand begins to be reactivated by the government itself because of strong social pressures. As sales begin to increase, fixed costs and profit margins may be reduced.

The above analysis clearly shows that the competitive sectors, along with the workers who lose their jobs and have their real wages reduced, pay the costs of the recessive policy adopted by the government. Only the big oligopolistic corporations are able to transfer their losses from the retraction in demand to consumers by accelerating their price increases. Sooner or later the workers and the competitive sectors will try to cope with their losses from recession and from the deceleration of their wages and prices.

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