THE ACTUAL IMPLICATIONS OF INFLATION

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Abstract:. *The authors have started from the idea that inflationary phenomenon is a companion, the cause and the effect of the globalization of poverty in the broader context of world economy globalization. Therefore, starting from a common definition of inflation, the first objective was to identify causal relationships that singularize contemporary inflationary process. After that, attention was focused on the implications of inflation in the current stage, bearing in mind that monetary financial theory and practice are operating with perfectly anticipated inflation or imperfectly anticipated inflation. Inflation has great implications on the long-term contracts and wage contracts.*
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1. Defining inflation

Generally regarded, inflation is synonymous to growth. In current terminology of financial monetary theory and practice, how the term was used but conferred it a more restrictive sense. Inflation is increasing the price of merchandise (goods and services in the categories of national accounts) expressed in monetary terms. The price is always a relative price, meaning that it is a good price in terms of another property, used as cash.

In an extreme situation in which there would be only a commodity and a currency, inflation is easily measured, it is equal to the increase in time of the number of monetary units required to obtain a unit of merchandise. If one chooses as cash the considered goods and not the currency, the latter remains, however, a general purchasing power, which may be changed at any time against other goods, although it is not, defined starting from role as cash because it may very well not fulfil it. Inflation is defined in these circumstances as a reduction in the price of goods.

Things are quite different when there are a large number of goods. Inflation is then defined as a price increase in the currency of a specific "basket of goods". The definition of the basket, as well as the measurement of inflation, however, are arbitrary, for which reason the inflation measurement depends on the initial choice of the basket of goods.

Similarly, at the national economy level, we can say that inflation represents the difference between the average annual rate of growth of the nominal gross national (domestic) product and the average annual increasing rate of the real gross domestic product, due to a generalized increase in prices of goods and services; the inflation rate represents just the percentage increase in the general level of prices and tariffs in a given period.

2. Causality in inflationary process

It is obvious that understanding inflation involves recourse to the theory of prices, because it is a variation (upward) of price. According to a general statement, the evolution of the relative price for two merchandises or goods reflects the evolution of their relative scarcity, which in turn reflects the evolution of relative offer and demand of the goods concerned. Inflation necessarily implies, therefore, a growing relative scarcity of goods in relation to the currency that is a growing relative abundance of the currency in comparison with the goods. Under such circumstances, inflation is always and everywhere a monetary phenomenon, or in other words, there is no inflation without a growth, considered excessive, of the quantity of currency.

It is essential to make two, as follows:

First, the claim that inflation is always a monetary phenomenon implies the existence of a relationship between inflation and monetary growth (in relation to increasing the quantity of goods), but that does not mean that it would be a causal relationship. Therefore, in an inflationary process it does not necessarily happen an initial increase in the quantity of currency followed by an increase in prices. It may be that the causal sequence starts from the prices increase towards the monetary growth. Therefore, an inflationary process mandatory involves the existence of a monetary "excessive" increase at some point.

Secondly, there are differences between the theories of inflation. In logic, all of them must accept the common base already given. A theory of inflation that does not relate to this base needs to be rejected as pseudo-theory. It is t he case of the so-called non-monetary inflationary explanations, such as those assigning inflation to productive or commercial structures, to the conflicts between socio-professional classes or to the increase of a certain price (for example, of raw materials or labour). Should be also rejected the distinction that is made frequently between "inflation through demand" and "inflation through costs", because the growth of certain production costs is manifested by inflation in the prices of goods only if they produce an "excessive" increase in the quantity of currency, and higher demand for goods, expressed in monetary terms, is only the manifestation of an offer of money against goods, all due to an "excessive" creation of currency.

Therefore, inflation theories are different in relation to this general framework, either by the different way in which they specify the explanatory factors of the demand for currency, or by the way they are favouring certain causal relationships.

From this point of view, one can distinguish between three main theoretical currents.

The first is represented by M. Friedman and the monetary school, according to which the demand for currency depends on the preferences of individuals, of their property or permanent income, on prices and on the efficiency of different current assets substitutable to the currency. Moreover, the income is determined exogenous, i.e. outside the monetary model itself, of which reason the important relationship is that existing, at least in the long term, between the quantity of currency and the general level of prices.

The second is represented by the Keynes-ists, for which there is no privileged relationship between the quantity of currency and prices. Prices may be rigid and not react to a monetary impulse. Thus, in certain circumstances, the increase of the amount of money can be manifested through an increase in income, not only by an increase in prices.

The third is represented by the Austrian school, especially by Ludwig von Mises and Friederich von Hayek. They retain a relationship between currency and price, but believe that other phenomena are more important. Thus, Hayek says he has no intention to criticize the positive content of the quantitative theory, on the contrary, he is even willing to admit that it is true as such and that the worst thing that could happen would be that the public opinion no longer ever believes the elementary enunciations of the quantitative theory. He disapproves nonetheless the global approach of this theory and the attempt to establish direct causal relationships between the total amount of currency and the general level of all prices and eventually the total production, because none of these sizes are ever influencing, as such, the decisions of individuals [in the work "Prices and Production, London, Routledge, 1931 - trans. Fr., Prices and production, Paris, Calman-Levy, 1971, p. 62].

3. Implications of inflation in the current period

Currency is a purchasing power in abeyance, in the sense that it is useful only to the extent that it can be exchanged for future goods. In consequence, inflation is inevitably a prejudice to the quality of the currency and, as such, it is detrimental to currency holders, because it represents a reduction of the currency price in terms of goods, namely a decrease in its purchasing power.

Holding currency means accepting a sacrifice now, because by buying the currency one is dropping the enjoyment that other goods could offer. If the holding of currency does not result from an act of coercion, it means that it is desired and is expected to generate future earnings; in an uncertain environment, holding monetary returns ensures the possibility to obtain the desired goods when elected.

The service carried out, thus, by the currency, which can be called liquidity service, depends however on the ability of the currency to maintain its purchasing power. Currency holders are interested in the real value of their revenues that is the value expressed in terms of real purchasing power. In modern monetary systems are sold, however, nominal charges, expressed in monetary units. When they find that inflation has occurred, that is the purchasing power of nominal revenues diminished; owners of currency can reconstruct the actual revenue value by paying off nominal revenues so as to maintain the desired amount of their real revenues.

The sacrifice that is therefore required is sometimes called inflation tax. If they predict that inflation will continue, they are obliged to adopt behaviour of "race against currency", that is not to reconstitute the full value of their real revenue. Thus, inflation will be higher and the real income lower as currency producers create more nominal revenues.

Therefore, inflation inevitably leads to a sampling of the value at currency holders' disposal. But there are other important effects of inflation, which are manifested, for example, by variations in the relative prices of goods or a variation of the relative price of the future in relation to the present, namely through a change in interest rates. Such effects are not present and do not appear, however, always in the same way.

The implications of inflation are different as this is perfectly or imperfectly anticipated and after the methods of protection used.

In the case of perfectly anticipated inflation, it is assumed that for a long period of time, inflation has reached an annual average value and that everyone has anticipated that will be at the same level in the following period too; all contracts will be build on envisaged inflation. Both those committed and those who granted the loan agreed that the currency in which the loan will be reimbursed will worth less than the currency released by the creditor in the moment he gives the loan. To counterbalance the effect of inflation, the nominal interest rates will be increased with the same value. To answer the same purpose, the nominal wages will increase too in the long term, with the same value, which will reverberate on any changes in real wages, which could be agreed later. Any contract that involves the evolution over time will take into account the envisaged evolution; here we can also include tax legislation, which will include appropriate indexing - taxes and duties instalments will increase annually with the same value. In such an economy, inflation has no real costs, with the exception of two particular situations: first, occurs as a result of the fact that there is no interest on money in circulation, while the second refers to "menu costs "of the inflation.

Non-anticipated inflation introduces an additional element of risk, which removes some exchanges between business world and consumers. This is, indisputably, a cost associated to the non-anticipated inflation, but one difficult to measure. One important effect of inflation is the change in the real value of the assets recorded in nominal terms. Through inflation is redistributed the national wealth from creditors to debtors. The prices increase reduces the purchasing power of all debts or assets recorded in monetary terms. The effect of redistribution acts at the level of all assets in terms of assets creation.

Monetary prices of goods increase in the inflationary process, but not necessarily at the same pace. In the purely hypothetical case, in which the relative offers and requests of various goods between the beginning and the end of the respectively process would not change, in the long term it would retrieve relative balance prices. In the short term, however, there are involved all sorts of variations in the relative prices. This is because prices do not increase mechanically, but are determined by individuals who react differently to the inflationary process; it differs the duration of contracts, the levels of information, buyers and sellers anticipation as to future prices, producers' strategies etc. One of the inflation costs comes, moreover, from the fact that economic agents are increasingly hard to know and to foresee the relative costs that concern them.

These remarks allow a general response to a difficult and important question of the economic theory, namely how to explain that economic activity can be volatile, meaning that adjustments are apparently imperfect, given that prices react to changes in requests and offers and that they are an essential tool to adjust to the change.

The analysis is based on a common antagonism between Keynes-ists and Monetarians, but it could be that, in the case in question, this opposition is not essential, especially to the extent that Keynesian theory is not a fundamental theory of inflation, and simplifying somewhat things, is concerned over quantities evolution than the prices evolution. Keynesian theory promotes the assumption of the monetary illusion, which is quite curious, would only affect employees - they are sensitive to the nominal value of their salary and not its actual value. The idea may be a rationalization of the curve (curves) of Phillips, is the inverse relationship which would exist between inflation and unemployment rate - employees would be stimulated to work more during the inflationary process, if they are proposed a higher nominal salary, despite the fact that their real wage is actually declining.

The differentiation of the assumptions on the evolution of the relative price is clearer when the Monetarist theory is compared with the Austrian school theory [Sechrest LJ, "Austrian business cycle and monetarist theories: substitutes or complements?", and Shan PJ, "The Theory of business fluctuations new Keynesian, old monetarists, and Austrians", in Boettke PJ, Kirzner IM and Rizzo MJ ed." Advances in Austrian Economics, Greenwich, JAI Press, 1997, vol 4].

Monetarists stress the labour market, namely the distortions induced by inflation between nominal wage and salary real, and grant, in fact, a critical importance the inflationary anticipations, while Austrian school economists focus on the capital market, namely the distortions induced by inflation between the nominal and real interest rate, and give weight to the way the additional currency is introduced in the economy.

Inflation is necessarily accompanied by an excessive creation of currency; thus who come across the problem of currency creating systems and their ability to produce more or less inflation. A monetary system is considered to be better as it better avoids inflation, that is incorporates processes of control and limitation of money production. When the currency is represented by the goods (for example, pieces of precious metals), the amount of money can not be manipulated. Certainly, it is possible the evolution of currency relative price in relation to the price of other goods, but an inflationary process can not be envisaged ex nihilo. The same happens when there are put in circulation certificates representing ownership rights of coins - goods, but these certificates [banknotes, in the terminology of Ludwig von Mises, "The Theory of Money and Credit, Indianapolis, Liberty Press, 1980] are likely to allow an infinite monetary expansion and lead to a continuous inflationary process if they are issued in the exchange of some debts and if there is no institutional mechanism to limit this expansion.

Therefore, Monetarists reached the conclusion that commercial banks should be imposed a sort of a monetary constitution, which would prohibit them to overcome a certain monetary mass. The advantage of this rule is that it helps agents to adopt realistic inflationary anticipations, but should not be forgotten that the best control mechanism is competition. In a free banks system, in which each bank issues its own monetary substitutes and offers a convertibility guarantee at fix price against a real good (for example, gold), currency producers, in order to not lose customers, are stimulated to produce a good currency, that is to avoid inflation [P. Salin, "La verite sur la Monnaie, Paris, O. Jacob, 1990]. Austrian school economists sustain, in the majority, this solution. In turn, Keynes-ists expect, on the contrary, an open flying policy (fine tuning), to give monetary policy a role in the conjunctural adjusting - they are not concerned with limiting the power of money creation.

The power of money creation depends, however, mainly on the currency systems adopted. In a system where the exchange rates fluctuate freely, currency producers determine in an independent manner the rate of increase in the quantity of currency through monetary policy tools. It follows, therefore, different rates of inflation in each monetary system. In a system of fix currency exchange rates, money producers can not determine the rate of growth of its mass. This rate is determined from the outside, and the rate of inflation is imported (in fact, in a system with n coins, can be independently determined only the mass of a coin, the other n-1 monetary policies are dependent). So, in this case, monetary growth does not cause inflation, but rather, inflation determines monetary increase.

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