Inflation as a Distribution Problem, as well as a Monetary Phenomena

(Macro Economic Analysis of Inflation and Stagflation in Less Developed Economies)

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This paper intends to address the problem of inflation in less developed, and transitional economies, and where the institutions of market is not fully developed and well functioning. Following the introductory analysis of the issue from Post Keynesian view and the Monetarist orthodoxy, it will be demonstrated that current Neo classical analysis based on rigid Monetarist views fails to address the problem properly in the socio- economic environment of the less developed economies, and as a result its policy prescriptions do not succeed.

Inflation as a major macro-economic problem in developed economies can be viewed either as an institutional problem deeply rooted in the structural behaviour of society, or as a short run monetary phenomenon simply because of a mismanagement of public finance and monetary system.

While Post Keynesian views are mostly focused on the structure of the economy and the nature of distribution, the socio-economic structure of the economy and the role of relevant social institutions.

Although the Keynesian / Monetarist argument on effectiveness of stabilization policy may simply be treated as an interesting academic debate in western developed countries, the issue of persisting inflation and subsequent government policy makers, and the professional economists. Consequently a realistic analysis of the problem should consider both structural aspect of the phenomenon in terms of the capacity of social institutions and distribution pattern prevailing in the economy, as well as the short run behaviour of economic agents.

Key words: Inflation, Relative Prices, Monetary Policy, Unemployment, Developing Economies.

Argument on General Perception from Inflation

In an introductory context inflation is usually defined as " overall rise in prices", that is also how public understand of inflation. But how do we add up all price changes into a single number. As economists we use price index, and in doing so deal with statistical methods, such as sampling and probability models, etc. We also utilize economic analysis to define these indices in a meaningful way.

By designing and using price index for measurement of inflation, we usually assume certain statistical properties to the figure we call the rate of inflation, which may or may not reflect the exact reality about variation in prices.

These implicit assumptions are as follows:
i) Regarding a given rate of inflation representing the overall price rise, it is assumed that, as if all prices change in exactly the same proportion.
ii) This overall change in prices is not related to any relative price change.

This seemingly innocent compromise in interpretation of the concept of inflation, in fact implies a unique pattern of change in prices, which is incidentally suitable for a given theoretical approach to macro-economic equilibrium analysis, and also bears particularly convenient economic properties for a specific policy conclusion.

It implies, among other things, an equiv-proportionate change in all the prices across the economy, which means no change in relative prices. This is a crucially important hypothesis, which needs to be closely examined.

It is not difficult to imagine that for a given rate of inflation, the combination of possible price changes for various commodities, which may be observed in a market economy, are almost infinite. Unless one makes an "a priori" assumption that all the changes occurring in prices are equiv-proportionate, there is no reason to ignore the role of relative prices in economic fluctuations in general, and inflation in particular.

In fact, a totally proportionate change in all prices, if possible at all, is not reasonably probable. It can also be demonstrated that such an inflation is quite exceptional, and with little or no impact on economic activity.
Because during such an inflation all the prices, wages, and interest rates are assumed to rise in the same proportion, with no change in actual purchasing power of the currency. This type of an inflation would not require any policy action to be halted, and could be properly termed as a " Neutral Inflation "

But, it is obvious that what we are faced with in reality, are not neutral at all. The types of inflation we are dealing with, and have difficulty in treating them, are not neutral in their composition. On the contrary, most of what we call inflation, are in fact general rise in prices with no proportionality among them. That is inflation with substantial changes in relative prices, and even inflation mostly as consequences of the dynamism in relative prices.

It certainly is not logical to assume that economic dynamism, and changes in relative prices are all short run phenomenon, and the underlying cause of inflation in the long run is exogenous growth in the stock of money.

Despite the role of relative prices in macroeconomic fluctuations, many economists tend to suffice with the study of inflation on the basis of an entirely hypothetical model, because of its simplicity, or for the sake of full compliance with requirements of the common neoclassical reasoning. As a result, the state of policy analysis in dealing with inflation can best be described as dismal.

Shortcomings in Conventional Anti-Inflation Policies

The so called conventional economists blame the Keynesians or activist economists for the high rates of inflation. Although, it is not far from reality to relate certain episodes of high inflations, particularly in less developed economies, to excesses in aggregate demand management in some cases, but it should be added that too passive monetary policies have also contributed substantially to persisting unemployment and stagnation on many occasions.

Generally, the lack of a clear analogy on dealing with inflation and other major macro-economic issues is considered as a serious shortcoming to the credibility of the profession. Trying to plan for everything by a single monetary aggregate, and discount the structural policy implications of targeting for growth and employment, are very costly in advanced industrialized economies, as well as in less developed world.

Neo-classical economists assume an ideal condition, where the economy is always in full employment equilibrium, and thus the unemployment level can not be lowered without an increase in inflation.

The very fact that in a comprehensive analysis, inflation is shown to be

influenced by changes in expectations based on relative prices, indicate that there is a correlation between inflation and real output, or employment and unemployment. Though the relationship has proven to be much more complicated than one could imagine, probably because of the role of expectations and relative price dynamism, yet to be identified.

This in itself is sufficient to reject the exclusivity and universality of the quantity theory of money as the sole explanation for sustained inflation. Yet, for many years now practicing economists in central banks have been loyal in listening to neoclassical preachings of passive monetary policies.

As a result for an extended period of time, most economies have been subjected to the consequences of policies that focus exclusively on inflation. Inflation targeting have become fashionable among various countries. Advanced western economies, which enjoy reliable body of data have contemplated using theoretically advanced indices like " NAIRU ", that is non-accelerating inflation rate of unemployment, in their policies for controlling inflation. While many transitional, and developing nations have launched monetary policy packages for achieving and sustaining a low single digit inflation.

Most of these policy plans have been rather costly in real economic terms, that is in terms of lost employment and slower growth. Whereas, there is no empirical evidence that a moderate rate of inflation, has any real harmful effect on output and employment.

According to many conventional economists there is a given natural rate of unemployment for a particular economy, which can not be changed by policy makers. But the counter argument is that in reality the oversimplified ideal model of a neo-classical economic system, can never be realized. Governments all over the world are expected to act firmly for implementation of a packages of policies, to not only contain the inflation, but also to help the economy operate at a higher level of output and employment. This in itself requires a more realistic view of inflation, and its relationship with other variables.

The Role of Relative Prices in Inflation

As mentioned logically one expects any change in prices to come from

a change in relative prices, and in the context of economic theory, there are many grounds to for elaboration on the nature and causes of change in relative prices.

In reality as well, close examination of extensive data for the prices of goods and services that constitute the price index, CPI and others, indicate the fact that fore most economies, relative prices do change during episodes of significant inflation. In fact, it is very hard to come across a case for the changes in various prices to indicate a fair degree of proportionality.

It is obvious that the concept of relative prices is of paramount importance in the whole body of economic theory. It is also important in the analysis of practical issues of political economy. But despite all this, the common assumption about inflation is widely used by academicians, and professional economists, with little or no explanation on its intellectual and practical implications in reality.

Based upon this rather naive assumptions about inflation, it is simply concluded that, as an integral part a perfectly competitive economic system , there exist a fully stable set of relative prices, which is permanently capable of allocating resources in the most efficient pattern, and in the absence of an odd exogenous shock, the system will continuously keep functioning with no ad-hoc change in prices or quantities. What one needs to add to this system is a basic relationship between the "overall" trend of change in prices and money in order to conclude that the cause of inflation is an exogenous growth in money supply!

It is noteworthy that technical advances has played a great role in postulation an development of vigorous mathematical models used by modern economists, but in spite of all these, it is a pity that the profession has to give way to an oversimplified model of inflation for such a crucial issue.

Theoretical elegance and technical vigour can be put to a better use, if we do not insist in an old dogmatic view, and try to utilize the advanced technical instruments in relaxing the hypothetical assumptions of theoretically ideal model, and come to terms with more sophisticated models of real world.

There is no doubt that, like all other sciences, in economics too, abstract models are essential for theoretical analysis, but no scientist ever resists the motivation to develop practically useful models for better explaining the real world, by systematically relaxing the hypothetical assumptions and replacing them with observation backed realities.

According to classical theory, changes in relative prices are caused by real shocks, which are not always expected to lead to an overall increase in the price level. But, it is certainly known that there is a relation ship between the rate of inflation and a substantial variation in relative prices.

Although it is some how costly to measure the variability of relative prices across the economy. But it is not impossible to design models for sampling in more important sectors of the economy.

The relative price change of a given commodity in relation to aggregate price index such as CPI, or the price deflator of GDP, can be defined by comparing the changes in one as compared to changes in the other. For instance, if the rate of increase in the price of houses exceeds that of the overall inflation rate, it is said that the relative price of housing has increased.

As for measuring inflation and analyzing its relationships with major variables, a realistic model should include, among other things, the effect of changes relative prices, which has a significant distribution effect, and as such can explain a great deal about macro-economic fluctuations. These variations in relative prices can be expected to happen for a variety of reasons, namely;

Economic reforms and liberalizations, which brings about substantial changes in subsidized prices, and sets a price shock by liberalizing certain industries.

Trade policy changes, which alters the extent of influence from international prices, and could vary for various industries.

Labor union actions, which changes the wage structure for certain industries.

Monetary and banking reforms, which may change the structure of interests.

Foreign exchange and investment rules, which alters the condition for trade and investment across the economy.

Tax laws, which may promote or restrict certain economic activities.

Although, most advanced market economies may seldom experience policy shocks of this nature, which can change relative prices and influence the rate of inflation to a significant extent, but this type of exogenous shocks and many others are common day developments in many transitional and

developing economies around the world. A more realistic and practical approach to economic policy is therefore a necessity for implementation of a successful stabilization policy in these countries.

For the purpose of designing a policy model useful for a rather dynamic economy, that characterizes most of transitional and developing countries, it is essential to distinguish the effect of two different categories of variables which influence inflation from one another. That is the influence of money and monetary aggregates as compared to the influence of major changes in relative prices.

It can be established that by using a simple factor analysis method, we can measure the effects of two categories of variables separately, for this purpose a set of components, or factors are produced:

One factor measures the size of common component in all price changes, that affects all prices equiv.-proportionately, and in a monetarist analogy, may be taken as the influence of money growth across the economy.

The other factors measure the effect of major changes in relative prices, such as, tax shocks, liberalization shocks, major union wage changes, tariff restructuring, subsidy plan reforms, etc.

By using this sort of analysis, one can compare the relative size of each factor influencing the rate of inflation. Once the magnitude of money growth on inflation is realized, and separated from the others, it may be termed as " The Monetary Inflation " , and dealt with accordingly.

Our preliminary findings from a model run for certain recourse based economies conclude that less than half of the observed inflation can be traced back to changes in monetary aggregates. That is to indicate that more than half of the inflation originates from changes observed in distribution patterns as represented by changes in relative prices.

Stabilization Policy Priorities for Developing Economies

As we explained, many economists, the policy makers and central bankers

in developing countries are following their counterparts in fully developed western economies, and are engaged in designing and implementing policy packages focused exclusively on fighting inflation. While, even their colleagues in the west have little to gain from such one dimensional policy models, it is paramount importance for developing nations to employ their economic professionals in development of policies endogenous to their own economy.

It is noteworthy here to indicate that with world economy suffering from financial crisis, and food and energy shortages, policy priorities for economists in these countries are in no way similar to that of their counterparts in the industrialized west.

It must be noted that the great emphasis on policies that focus mainly on inflation, may lead to the exclusion of more important concerns, such as growth promotion, employment creation, poverty elimination, social infrastructure development, etc., which have to be placed higher in priority list of economists in developing countries.

Experiences of liberalization in eastern Europe have indicated that during initial periods of structural reforms, the impact of relative price change and its distribution effects, could very well be above that of monetary shock alone. In order to pursue structural reform programmes, the policy makers should take into account the full impact of distortions arising from such distributive shocks, and their effects on relative prices, if they are concerned with the ultimate health of the economy.