NOTES- *ON COSTS AND CONSEQUENCES OF INFLATION BY AXEL LEIJONHUFVUD*

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The neo-classical theory often is the starting point of analysis of micro-foundations of macro theory The argument that inflation-tax causing production and transactional inefficiencies is fallacious. The Welfare Cost assessment of neo-classical theory trivialises the cost of inflation.

The General Equilibrium model can be described as one of multilateral barter system. The costly and inefficient nature of barter can explain the use of money but it cannot be used as historical generealisation. '…where monetary exchange does not prevail, neither do we find predominantly "private" property rights, commercial contracting and organized markets.'(pp.229). 'And paraphrasing J.S.Mill, "competition is the governing principle of such contracts" as leave particular agents with a debt-claim relationship.'(pp.230).

The neo-classical analysis separates economic aspects from the rest of social analysis. The repercussions of socio-political system are taken as given through the *ceteris paribus* assumption. 'The neo-classical conceptual experiment of steady-state inflation, which in time accurately foreseen, and to which "everything adjuts"-execept property rights, contract forms, and the organization of markets…'(pp.231). These being in the domain of long run are bound to change and hence institutional *ceteris paribus* assumption be dropped. ' The stability of any social system requires, 1. an exhaustive and consistent allocation of rights to economic resources, and 2. rules for the transfer of these rights and means for keeping track of the legitimate succession to them.'(pp.232).

'The law is helpless to assure that a just real outcome is restored to contracts concluded in nominal terms. The expectations about the rate of inflation in prospect that the two parties held cannot be objectively ascertained after the fact.'(pp.236-7). This brings in the role of judicial system. Because the contract is addressed in nominal terms, there is real loss to creditor if actual inflation is higher than expected or that assigned in the contract. Such losses cannot stand in trial. Another example would be the loss in the Saving Bond or Saving Scheme due to the inflation. 'The outcomes of any individual's effort are contingent upon the present and future behaviour of others. The law seeks to provide a stable framework of social interaction within which people can form expectations about the outcomes of their actions sufficiently firm, if not precise, to allow to plan their conduct accordingly.’(pp.238). Denying complete set of contingency markets of Arrow-Debreu model Leijonhufvud points out that, ‘And this would be a true statement- no contract will explicitly cover all those contingencies that can be envisaged, for it does not to pay to do so. But, beyond that, the conditions of human understanding will not allow for the anticipation of every relevant contingency.’(pp.240).

Another problem with respect to inflation and the law is indexation. It brings with it the baggage of index number problems as even if a composite basket for which indexation is agreed upon, inflation rate is uncertain and vary measured by Laspyere or Paasche’s index. Also, ‘…that use of one common index number to scale up nominal income proportionally will not leave real income among income classes unaffected.’(pp.243). ‘In any case, it is clear that private parties contracting on an index basis will thereby (a) redefine the sets of adverse and favourable contingencies for themselves, and (b) to the sub-set for which some measure of redress can be sought. And, to repeat, they are not doing it.’(pp.243-4).

The output-loss due to inflation has drawn the attention of the economists. ‘The assumption that, once the output loss (if any) attributable to inflation has been estimated and taken into account, the Social Consequences of inflation end with its redistributive incidence may be the single most serious stupidity to which economists are prone to when discussing inflation.’(pp.245-6). An individual will change his beahaviour and adapt to the circumstances even when his *ex-post* net worth remains the same during the period of inflation. Unlike in the case of perfect competition models, instead of playing for efficiency gains, predicting inflation becomes crucial for economic survival. ‘People will reallocate their effort and ingenuity accordingly.’(pp.247). This will substitute public political for private economic ways of goal seeking. Instead of problems like unlike unemployment, inflation induced demands will be informationally biased. Among others inflation may induce demands for tax-cuts and proliferation of governmental control. It may also unsettle past political compacts and compromises. The political institution gets overloaded with issues more than it can handle entailing inefficiencies. ‘The rights, immunities and obligations with one goes to bed night must be there in the morning and not found unpredictably reshuffled or a meaningful social existence becomes impossible.’(pp.253).

Transactors will not be able to sort out the relevenant “real” price signals from the relative price changes due to these inflationary leads and lags. (pp.259, italics original).