Nota Técnica

A Monetarist - Structuralist Debate on Inflation

No es nuevo que algo que estuvo de moda vuelva a estarlo. Este es el caso de la inflación latinoamericana y mundial durante el 2008. No es algo deseado, por cierto, sobre todo cuando los bancos centrales parecían estarlo haciendo mejor que en el pasado: tenían prácticamente controlado uno de los males económicos sobre el cual más se ha escrito en el último siglo. En una revisión de los variados ensayos que debí realizar en Londres me topé con uno que despertó mi curiosidad, por los elementos que involucraba, más allá de compartir o no su fondo. Las presentes líneas son un extracto "acondicionado" de ese documento, cuya pretensión no es revivir viejas discusiones, sino más bien mostrarle al lector algunas de las variables que alguna vez estuvieron en la mesa de este debate.

Introduction

For a long time there has been a huge controversy about the origins of and cures for inflation between monetarists and structuralists. Especially in the past decades the debate between these two schools was very bitter.

Structuralism emerged in its initial formulation in the fifties with the publication by the Economic Commission for Latin America (ECLA) of two documents: "The Economic Development of Latin America and Some of Its Main Problems" and "The Economic Study of Latin America", and represented a doctrine elaborated by Latin American economists in reaction to imported theories judged to be a poor explanation for inflation in less developed countries. With these articles ECLA began to enquire into the causes and cures for inflation. For structuralists inflation in less developed countries arises mainly from structural maladjustments and rigidities generated by the process of development itself.

The monetarist viewpoint, which had in M. Friedman the major exponent, has its roots in the classical and neo-classical theories. Its simplest thesis points out that in a perfectly competitive economy and in absence of other externalities, market forces operating through the price mechanism – markets are postulated to be price clearing – assures an optimum allocation of resources. For monetarists inflation is exclusively a monetary phenomenon arising from excessive demand and in particular when there is "too much money for few goods".

At the end, it is possible to stress that while for monetarists inflation is seen as incompatible with growth, independent to the economic context we are talking about, for structuralists this problem in less developed countries constitutes a natural accompaniment of the growth process.

An Overview of the Monetarist Belief

Inflation is easily defined as a persistent and permanent increase in the price level. For monetarists it is impossible to have true inflation, as defined above, without an increase in the nominal money supply. This increase arises, in a closed economy, from new (issued) money – called exogenous – or from endogenous money (banking credit). Even though the banking multiplier have something to say about the level of monetary supply, it is thought to be relatively stable for somewhat short periods of time, having little influence in the growth of money. Thus, the monetarist viewpoint first of all asks for the role played by the Central Banks (or monetary authorities) in order to reach a good explanation of the inflationary process elsewhere.

If initial stock equilibrium is assumed in the market of money and there is an increase in the nominal income - due for instance to fuel the industrialization process – the nominal demand for money will rise. But, if the monetary authorities decide to have a higher rate of increase in the nominal money supply than the change in the demand side, inflation will be inevitable. Both, the increase in the inflation expectations and the lower real income will produce a fall in the desired real demand for money. People will spend quickly the undesired monetary balances, thus provoking a higher rate of inflation. This process stops only when the stock equilibrium is restored.

Two facts can be stressed in this monetarist analysis: The first is that the higher inflation the lower will be the real income. The second is that inflation will depend on the difference between the rate of growth in the money supply and the demand for money, both in nominal and real terms.

The monetarist conclusion is as inflation in the economy is purely a monetary matter, the only way to stop it quickly seems to be the curbing of excess demand through a reasonable combination of monetary and fiscal policies, which can be supplemented – especially in less developed countries – by international financial assistance.

The Structuralist Approach

For structuralists inflation has two components. The first are the basic or structural pressures of inflation. The second is the propagating mechanisms of this problem. The characteristics of these structural pressures and propagating mechanisms can vary from country to country.

In this approach, inflation arises mainly from structural maladjustments, bottlenecks and rigidities in the economic system, all of which are related with some kind of inelasticity, especially from the supply side of the market. Hence, inflation can be eradicated only through elimination of the bottlenecks found in the basic components of the inflationary process.

Three are the most important origins of basic inflationary pressures: a) coming from the imbalance between the agriculture and the industrial sector; b) coming from the foreign trade sector and c) coming from the public sector.

On the one hand, the agricultural sector is characterized by supply inelasticities and rigidities. On the other hand, the industrial sector is seen as a modern one, very sensitive to demand conditions, but dominated by oligopolistics firms. Here, if the income raise with the industrialization process there will be an increase in the demand for all goods – food and non-food commodities – but as the agricultural output is rigid and unresponsive to demand pressures, this will mean an increase in the price of agricultural products. Moreover, if prices in the industrial sector only shift in a very little proportion, this change in relative prices will cause inflation. The foreign trade sector has been characterized as having an inelastic supply of exports and instability in export earnings. The demand for Latin American exports was expected to grow slowly, due to low income and low price elasticity, and due to the development of substitutes on the part of developed countries. In addition, imports from these countries became inflexible to sustain the process of industrialization. As a result, increases in the price of imported inputs are transferred completely to less developed countries via cost structures, generating the acceleration of domestic inflation. This fact in the foreign trade sector will lead to periodic devaluations of national currencies. Rigidities in the public sector arise mainly from an income inelastic taxation system, which is considered inefficient. This means that a higher public expenditure cannot be financed by imposing an increase in tax rates.

The main propagating mechanisms of the basic inflationary pressures are public expenditure, competing income claims and upward adjustments in prices arising from cost increases. These mechanisms facilitate the transmission of price increases to the rest of the economy. The first of them deals with a public sector which cannot cut their expenditures. The government has obligations, such as the social support. In a context of a growing fiscal expenditure with an inelastic taxation system, inflation seems to be inevitable. Competing income claims are related to what has been called cost-push inflation. Workers will demand higher nominal salaries to compensate losses of real income. And firms will transfer cost increases to consumers by raising prices, especially due to the oligopolistic character of industry. Imperfect market structures will not only increase the price due to upward pressures on nominal costs, but also alter the used mark-up rule. In other words, inflation arising from various social groups trying to keep their share of income unchanged.

For this approach the cure for inflation comes from: Longer-term measures, such as agricultural modernization, reform in the taxation system, incentives for the diversification and industrialization of exports, and others, all of which are designed to remove structural rigidities and supply bottlenecks in the economy. Shorter-term measures deal with the propagating mechanisms of inflation and are very similar to what monetarism advocates, i.e., monetary and fiscal policies.

Monetarists and Structuralists: a Brief Comparison

The fundamental disagreement between structuralists and monetarists is about the causes of inflation. It is clear that those factors which monetarists regard as the origins of inflation are seen by structuralists as solely propagating mechanisms of the basic inflationary pressures. In the structuralist scope inflation cannot be curbed only through monetary and fiscal policies without provoking unemployment and stagnation of growth, because of the structural features of less developed countries. They don't deny the relevance of money in the economy, but they also consider that monetary and fiscal policies are not effective at all to stop inflationary processes in these countries. If inflation has a great structural character, the traditional approaches toward stabilization based on demand control will fail to check inflation completely.

For monetarists the causality goes from money to inflation. Structuralists claim that causality goes from inflation to money supply. In this case money supply is passive and is adjusted to the inflation, not the other way around. This hypothesis, that monetary authorities are not causing an expansion by their own initiative means that they are only accommodating monetary pressures originated outside the money market. For instance, with indexation (of wages and prices) money supply increases tend to be quite persistent over time, and inflation can become inertial and the cause of monetary expansion.

A key element in structural inflation is the high degree of immobility of resources, which prevents the structure of production from adapting itself with the velocity required by the pattern of demand. With limited supplies of food and non-food items, severe inflationary pressures may be generated even in absence of public deficits and with a relatively low rate of increase in the money supply. In other words, inflation could be expressed through changes in relative prices. This conclusion is rejected by monetarists, who argue that inflation is only related with monetary movements and that changes in relative prices without monetary shocks compensate each other, thus leaving the rate of inflation unchanged.

One direct implication of above is that while for monetarists it is enough to correct the demand side of the economy, for structuralists it is necessary to modify the supply side of markets too, basically removing bottlenecks and rigidities in the economic system. The removal of these obstacles requires structural reforms in order to promote production and increase the supply side of the market. Although monetarist measures might decrease in part the rate of inflation, they would mean a sacrifice in terms of economic activity and deterioration in income distribution. As inflation is a structural problem, people should learn to live with it and wait for a long term policy toward the elimination of rigidities.

In conclusion, for monetarists it is the inflationary process the main obstacle for economic growth. Inflation reduces the real income and thus the aggregate demand in the economy. Structuralists hold that inflation is a natural accompaniment of growth in less developed countries, since it is the outcome of structural features. Stucturalists attack the monetarist anti-inflationary policies for not tackling the roots of inflation and for leading to stagnation, unemployment and income inequality.

Summary of the Empirical Evidence

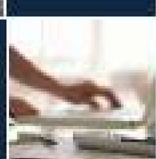
In general, the results of contrasting empirical studies between these two approaches support a broad model of inflation. Findings are consistent with the monetarist argument that excessive aggregate demand is responsible for inflation. But, the structuralist model is also supported by the finding that the rate of change in the relative price of food is important to obtain a reasonable explanation of the inflationary process in less developed countries. Since the price of local food and imported inputs has increased over time in many Latin American countries, this suggests that inflation in these economies has been higher than would have been if only monetary factors were considered. Of course, the evidence stresses this price variable along with the traditional policies of aggregate demand in order to limit the inflationary process.

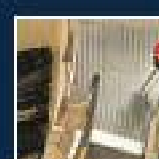
Another relevant point is that the higher inflation rate the most important will be the argument that money supply is passive and does respond to higher prices. Monetary authorities may increase the nominal quantity of money as prices rise, for instance, in an effort to prevent increases in unemployment. At lower rates of inflation the empirical evidence to support the structuralist position is weak.

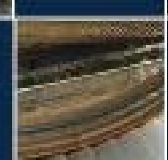
Profesor Luis A. Valenzuela Silva
MSc Econ.-Univ. of London
Dpto. Economía, Recursos Naturales y Comercio Internacional. FAE.
Universidad Tecnológica Metropolitana

UTEM









ISSN 0718-3933