

**INFLATION AS A DISGUISED MECHANISM  
FOR REAL WEALTH DISTRIBUTION****Malkhaz CHIKOBAVA***Ivane Javakhishvili Tbilisi State University, Georgia  
Malkhaz.chikobava@tsu.ge***Abstract**

*The article analyzes the public spending of inflation and the reasons for its permanence. It is noted that inflation negatively affects the finances, monetary and the entire economic system. It reduces the purchasing ability of money, undermines the possibilities of economy regulation, structural transformation, restoration of distorted proportions, distorts the real picture of the financial results of production, the level of consumption of goods and service.*

*The article emphasizes that accompanying product of inflation as a complex phenomenon is massive and uncontrolled distribution of national income and public wealth: Inflation is directly reflected on the real income of households and firms and causes the distribution of wealth among the economic subjects. In addition, as a rule, the poor become even poorer, while the rich become richer. Consequently, inflation sharply strengthens social differentiation in society and exacerbating social conflicts. Overall, there are huge public expenditures, which are universally recognized.*

*The article shows that the need for permanent payment of interest leads to the concentration of increasing supply of money in money circulation, which does not participate in economic transactions and, therefore, in the creation of added value. Finally, the concentration of extra money in the economy leads to inflation.*

*According to the author, inflation, whose permanence is due to the necessity of paying interest, despite its size, is the disguised mechanism for distributing real wealth in favor of the financially wealthy people in any society.*

**Keywords:** *Inflation, money, interest rate, seigniorage, open inflation, suppressed inflation, indirect taxes as disguised distribution of real wealth.*

**JEL Classification:** *E30, E31, E42, E43, E44*

**I. INTRODUCTION**

The concept of inflation is uniquely associated with negative processes. It is impossible to find a serious scientist economist who believes that the systematic growth of prices is a harmless phenomenon. The preceding increase of prices for goods, independent of the length of inflation wave, is an extremely painful process for any country.

Inflation adversely affects finances, money and the entire economic system. It reduces purchasing power, undermines the possibilities of economic regulation, structural transformation, restoration of broken proportions, distorts the real picture of the financial results of production, the level and dynamics of consumption of goods and services.

The massive and uncontrollable distribution of national income and public wealth is an accompanying product of inflation as a complex phenomenon: Inflation is directly reflected on the real income of households and firms and causes the distribution of wealth among the financial subjects, in particular in favor of borrowers from creditors.

In addition, as a rule, the poor become even poorer, while the rich become richer. Thus, inflation is dramatically reinforcing social differentiation in society and exacerbating social conflicts. Overall, there are huge public expenditures of inflation that are recognized universally.

Frequently, the implications of inflation include such things which are related to the wrong view. For instance, according to some views, inflation makes society poor in general, because its members have to buy less goods and services with money incomes. In fact, it is not the case, because the increased prices are transformed into producers' incomes. We must remember that if someone paid for goods more than before, another person will receive this amount as an income. In other words, incomes are rising as a result of inflation, however, of course, not everyone's income and in unequal amount.

It is more correct to say that the consequences of inflation depend on the quality of its forecasting possibility (when the economic agents are quite likely to predict the scales of the expected growth rates) or unexpectedness. Obviously, if inflation is predictable, the socio-economic losses acceptable from it will be

lower, as business decisions are made in the conditions of certainty. However, even in this case certain public spending on inflation is inevitable.

Which expenditures include a predictable inflation? First of all, inflation leads to the origination of so-called inflationary taxes paid by them who have money on hand or in current bank accounts because the purchasing power of money decreases. In addition, the state receives additional income from the emission of money in the form of "seigniorage." In countries with high inflation, seigniorage is the main source of state revenue.

## II. GENERAL ANALYSIS

People open savings accounts to evade inflationary taxes or they buy hard currencies. But they have to pay frequent visits to banks and currency exchange offices to make transactions. The time, energy, and financial expenditures, generated in this regard, are called "shoe-leather costs." (Mankiw, G., 2009).

The following types of expenditures resulting from inflation are related to the fact that the inflation impels firms to make frequent changes to the price lists. All this, of course, is related to a certain sum of money that is known as the "menu costs." (Mankiw, G., 2009).

Another loss from inflation is related to the peculiarities of tax legislation. Additional profits received as a result of inflation are taxed in the same way as ordinary earnings. Eventually, firms are practically taxed with higher taxes. For example, if the expenses of the company are 100 GEL, and the total income is 120 GEL, then the profit will be 20 GEL. Let's say, the tax rate of profit is 20%, accordingly, the profit after the payment of taxes will be 16 GEL. Now suppose that the prices doubled after the firm's expenses, which resulted in the total revenue of 240 lari (instead of 120 lari). Then the profit of the company will be 140 lari (240-100), and the profit after the payment of tax - 112 GEL (140-140 \* 20%). At first glance, net profits increased 7 times (112/16). The firm to continue its activities will still have to buy raw materials and materials, to hire labour force, etc., but all this is twice expensive due to inflation. Accordingly, from the net profit the firm will have to spend 100 GEL in order to maintain the production at the previous level. Instead of 16 Gel, there are already 12 lari at the firm's disposal, and at that the purchasing power of this sum is twice less considering the increase of prices.

The following types of inflation expenditures are reflected in life's inconvenience in the conditions of constantly changing prices, as it permanently becomes necessary to determine by which year's prices was made this or that calculation.

Unlike predictable inflation, unforeseeable (unpredictable) inflation undermines the market mechanisms of distribution of resources and products, which is why the expenses caused by this is much higher. The expenses incurred are as follows:

- A sharp depreciation of savings of firms and households. In particular, the firms' amortization fund is depreciated, which significantly hinders the reproduction process;

- Distribution of wealth from creditors to borrowers who borrow "expensive money" and return "cheap." For example, at the initial stage of post-communist transformation in Georgia (and not only here) one of the main sources of the fastest enrichment of "new Georgians" was the fact that in the years of hyperinflation they received a large amount of credit, and at that the annual interest rate was significantly lower than the annual rate of inflation. The sharp difference between expected and actual real interest rates, which was caused by unexpected inflation, disrupted the credit system and distributed the real wealth of the large part of population in favor of the individuals;

- Distribution of wealth from persons with fixed incomes, in favor of those whose incomes flexibly react to the changes of prices;

- Investment risks and growth of uncertainty, which reduces the volume of investments.

High inflation expenses are especially high, not to mention hyperinflation. Such inflation completely disrupts the economy, making it impossible for any business planning. Firms refuse capital investment because they do not know what prices will be on goods and resources after a few months. There is a deformation of consumer demand because the population seeks to insure against inflation by preliminary buying of long-term goods or invest in a foreign currency. Production becomes increasingly limited by speculative operations. Those persons suffer the lowest losses who timely managed to invest their savings in real estate, hard currency or other material values (for example, in precious metals), which only appreciate.

In addition, the costs of inflation depend on the nature of inflation – is it open or suppressed? If open inflation is showing a continuous increase in the overall level of prices and the reduction of the real value of private savings; under the conditions of open inflation banks keep depositors' savings if their interests on deposits exceed the current growth rate. This difference should be no less than the level of adaptive inflation expectations.

In the economy, where the inflation is suppressed, the savings holders' situation is more difficult. In the conditions of chronic commodity deficit the increase of interest on deposits gives no positive results. It can, however, prevent depreciation of savings to a certain degree, but it can not protect the economy from the total

deficit of goods when it becomes impossible to use savings in any form. During the suppressed inflation, it is impossible to escape the part of savings – especially the part of savings stored in cash and in the bank accounts. Obviously, for the purpose of minimizing losses, subjects must necessarily move gradually on to the open type of inflation.

Outwardly, it seems as if in the conditions of open inflation the situation of population is more profitable, as there is no commodity deficit and the measures taken by the state are being implemented. In fact, the welfare of population is decreasing in this case.

First, anti-inflationary payments can not outpace the dynamics of prices, as the latter is growing daily, while the wage rate and fixed incomes are adjusted after a certain period. The longer the periods are, the heavier losses are caused by inflation.

Secondly, predicting the expected level of prices, especially during unmanageable inflation, is extremely difficult. Trying to reduce the budget deficit and the cost of the economy according to any article, the government can not fully assess the inflation risk.

Therefore, antiinflation compensations, as a rule, are not always enough to keep income at an unchanged level, which makes the living standards fall inevitable. At the same time, over time the compensation itself provokes the growth of inflation.

Thus, open and suppressed inflation, however, with different doses, negatively affects the volume of savings and current consumption, which worsens the population welfare.

In addition, we believe that the public losses caused by inflation are incomplete. One point here is that, according to which, in the case of any pace of inflation, there is a hidden distribution of real incomes in the majority of the population in favor of the minority. Universally known economic schools, though, analyze the causes and consequences of inflation in depth, but in our view, none of them give answer to the question of why the inflation is inevitable. Nobel laureate in economics, Robert Solow says: “Inflation is not eradicated simply because we expect inflation, and we expect inflation because we’ve had it.” We believe that such an answer is not enough to understand the foremost cause of inflation. We have formulated our own opinion about it in the work: “About the causes of constant inflation.” (Chikobava, M., 2011). This time we note that if we draw upon the basic identity of the quantitative theory of money -  $MV \equiv PY$ , the rate of the growth of money supply for a long term, when the rate of rotation of the money is unchanged, must be equal to the growth rate of the real volume of production. In this case, the average level of prices, following from the quantity theory of money, should remain unchanged, i.e. the inflation rate should be equal to zero. It is obvious itself, that the rise in money demand is primarily related to the growth of transactions in the economy – growth of the commodity turnover. But, why does the average annual growth rate of money supply in the practice continuously exceed the average annual growth rate of the volume of production? If we try to align the average annual growth rate of the money supply with the growth rate of the real volume of production, then the reason for the change in the average level of prices should not exist for a long period: After a certain period the gain of the money supply will be exceeded by the amount of additionally produced goods and after a certain time lag the overall level of prices will return to the previous indicator. But the point is that in the sphere of money circulation, that amount of money is increasing which doesn't serve the production of goods and commodity turnover and is used to pay for additional money, or interest payments. Since the money has its own price, which is nothing more than a nominal interest rate, the society is taxed with an "indirect tax", or with interest, which leads to a higher increase of money supply that needs to be met to increase the real volume of production. In our opinion, this is the foremost reason for the constant inflation.

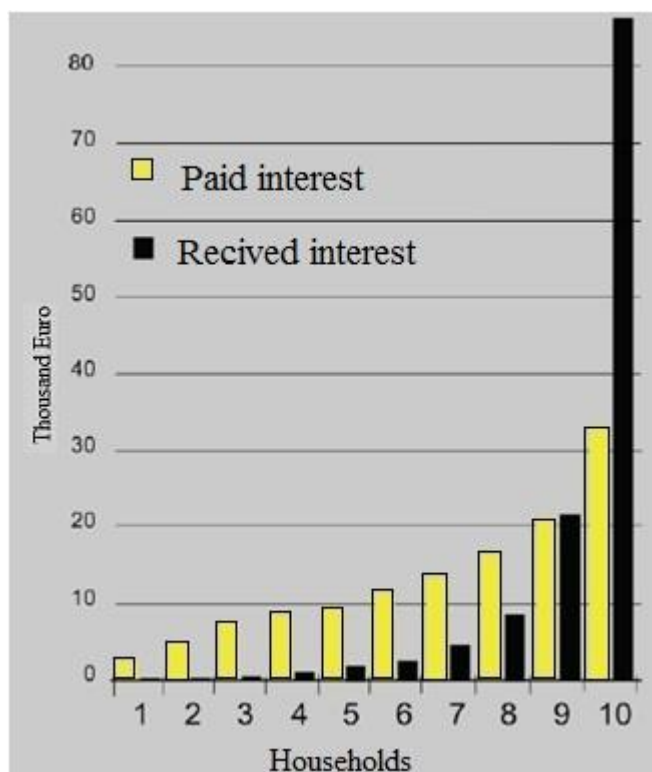
Relationship between inflation and nominal interest rate is analyzed by Irving Fischer, known as the Fisher's Equation. In this equation, the nominal rate of interest changes in the direction of inflation, or, in other words, the reason for the change in the nominal interest rate is a change of inflation. We believe that there is the following cause and effect relationship between inflation and nominal interest rate: the existence of interest is the cause of inflation and not the opposite. This is exactly the necessity to pay interest which generates inflation. If we consider public losses of inflation in this aspect, we will see that, inflation, no matter how small its annual indicator is, for the long-term dynamic series, initially the money resources and, on its basis, the real wealth is permanently distributed from the majority of the community in favor of the minority. We will try to make this point more clearly.

One of the margins of the modern money system can be formulated as follows: “Any individual who borrows money and pays the interest can earn income as a percentage by depositing money in the bank. The modern monetary system has the same positive (or negative) impact on everybody.” In our opinion, one moment remains beyond the focus of attention. In reality, within this system is impossible for all to be winners. The reason why it is difficult to fully understand the impact of the interest mechanism on the money system is its partial disguise. Most people think that they pay interest only when they receive money in credit and if the payment of interest is undesirable, it's just enough not to get money on credit.

In fact, the price of any goods we have purchased includes the percentage of interest that changes according to the amount of capital spent on the production of goods. So when we buy products, any of us, like

indirect taxes, are indirect payers of percentage. Below there is the percentage of interest and payment comparisons for 10 equal groups of Germany’s population (see Scheme). Each group consists of equal number of population, and each subsequent group is financially wealthier. Apparently, the first 8 groups of the population pay more percents than they receive them, while the 9th group receives more than they pay, and the last 10th group receives twice more than they pay. This is jointly that part which was lost for the first eight group of the population. This fact best illustrates the essence of the mechanism (possibly the most important), which enriches the rich and makes the poor poorer.

Interest as a means of securing money in the modern monetary system and as the main reason for permanent inflation, it is a means of disguised redistribution of money, which is based not on labour participation, but that someone can hinder the exchange of goods by saving means of exchange, even if it is a “reward” interest. Thus, the irony of the fate money flows from the people who have less than they need to those people who have more money than they need. This is another, more evident and efficient form of exploitation than the one that K. Marx wanted to eliminate. He was undoubtedly right when he pointed to the sphere of production of “extra cost,” however, the “extra cost” distribution is largely realized in the sphere of circulation. Today, at the end of the long period of economic growth and the separation of money from the golden standard, this is more evident than in Marx’s time. We will eventually get the situation in which a large amount of money will be concentrated in the hands of a small number of individuals and firms. According to the World Bank of Reconstruction and Development, the amount of monetary operations worldwide has significantly exceeded the amount that is practically necessary for goods exchange. (Helmut, Wachstum bis zur Krise, Verlag, 1986).



Comparison of received and paid interest in Germany in 2004.

**III. CONCLUSION**

Payment mechanism of interests, especially compound interests not only leads to the operation of a pathological development mechanism of economic and money supplies, but also it operates against fair rights in the majority of countries. (Kennedy, M., 2004). If the constitution gives a guarantee that any services provided by the state will be made available to each individual, and the monetary system may be considered as such, then the situation within this system, when 10% of the population receives more and more than they pay at the expense of 80% of the population, which receives less than pay, is absolutely unfair.

Thus, the inflation, whose permanence is due to the necessity of interests’ payment, regardless of its size, determines the disguised distribution of real wealth in favor of those who are financially wealthy.

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