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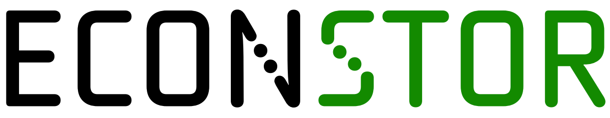
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Inflation and Economic Growth in LDCs

by Professor Walter Hamm, Marburg*

Economists find it difficult to reach agreement about the effects on economic growth of depreciation of the money value. One reason is that they define certain terms in different ways, another one is that many other factors as well as inflation have an impact on economic growth. They may intensify or compensate for positive and negative relations between inflation and economic growth.

The term growth as used in the following denotes the growth of the production potential of a country's economy. If production factors of which the economy has already a surplus (e.g. in many developing countries, badly trained workers) increase without a simultaneous improvement in the supply of the bottleneck factors (e.g. entrepreneurial resources, skilled workers, risk capital), there will as a rule be an increase in the stock of individual production factors, but not of the production potential as understood here. The term growth rate denotes the accretion of production potential, in percentage points, compared with the preceding year. The percentage increase of the gross national product (GNP) of an economy compared with the preceding year is called the accretion rate.[1]

Disparity of Definitions

The term economic growth is often used in the sense of increasing production potential as well as in the sense of annual growth rate of GNP, which can cause misunderstandings. In an economy with idle factor combinations an increase in overall demand (say, through deficit spending) will result in higher accretion rates but not, at first, in an expansion of the production potential. This circumstance is generally of no concern to less developed countries (LDCs).

The term inflation is also used in different ways. Any depreciation of the value of money however minute may be described as inflation or the term may be reserved for substantial price increases of 10 p.c. or more. Most economists will agree that a depreciation rate (i.e. a rise in the level of prices as measured by the price index for the GNP) of up to 2 p.c. is without detrimental effect on economic growth because price increases of this magnitude are below the sensitivity threshold and do not provoke defensive reactions from those who are injured by the price increases. A minor depreciation of the value of money, of up to 2 per cent a year, may even have a stimulating effect on growth because of the absence of a price recession, because of the decline in investment propensity which this usually causes in stagnating and contracting industries and also because of the consequent improvement in the investment climate in growth industries and because of the acceleration of factor transpositions.[2] In view of the fact that the controversy about the stimulating or moderating effect on economic growth of inflation processes is mainly concerned with annual depreciation rates of much more than 2 p.c., the term inflation will in the following remarks be understood to apply only to continuous, and not merely temporary, depreciation of the value of money by 4 p.c. or more per annum.

Of importance for an assessment of the consequences of inflation is by no means only the actual degree of money depreciation per annum but above all the current and anticipated inflationary trend, i.e. the changes in the rates of infla-

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[1] Cf. H. Giersch, Wachstumsförderung durch Geldwertschwund? (Growth Promotion by Money Value Shrinkage?), in: Wirtschaftswachstum durch Geldwertschwund (Economic Growth through Money Value Shrinkage), No. 11, Veröffentlichungen der Studiengesellschaft zur Neugestaltung des Finanz- und Steuerrechts e. V., Heidelberg 1971, p. 66.

[2] Cf. H. G. Johnson, Is Inflation the Inevitable Price of Rapid Development or a Retarding Factor in Economic Growth?, in: Malayan Economic Review, Vol. XI, No. 1, April 1966, pp. 22-28, reprinted in G. M. Meier, Leading Issues in Economic Development, 2nd edition, Oxford University Press 1970, p. 229.

tion in the course of time. This fact which will be referred to later is occasionally overlooked, especially in empirical studies.[3]

Inflation — Instrument of Growth Policy

Different answers are given to the question whether inflation is a promising instrument of growth policy, and this mainly for three reasons. First, the further repercussions of inflationary processes and state intervention brought on by them are often not taken into account in the analysis or at least not fully. Secondly, sufficient attention is not always given to the trend of inflationary processes. Thirdly, the assessment is often affected by different assumptions concerning the extent of "money illusion".[4]

To what extent are inflationary processes capable of promoting economic growth in the sense of an expansion of the production potential? Usually attention is drawn to the inflation-induced process of income redistribution which operates to the benefit of state, entrepreneurs and debtors and to the detriment of creditors and recipients of incomes which do not or only in part or after delay follow the inflationary trend. In LDCs it is as a rule the rapidly growing urban population which suffers from this process, sometimes described as "forced economy" and has to cut down on their spending for purposes of consumption whereas the accretion of wealth accrues to the state and to the entrepreneurs. Rising prices unaccompanied by an equal increase in costs result in growing profits and tend to stimulate an extension of the production potential.

It would be all too short-sighted to break off the train of thought at this point and to conclude simply that inflation was indeed promoting economic growth albeit in circumstances which under social aspects may be anything but desirable. Inflationary processes extending over a period of several years alter the mode of conduct of all concerned and force the state to resort to acts of intervention which at best jeopardise the desired object and will probably even lead to failure. Some of these further repercussions shall be mentioned here and their consequences for economic growth will be traced.

☐ The standard of living of wide sections of the population, low as it is, will be depressed further by the redistribution of incomes caused by inflation. To allay the discontent among the population, the prices of essential goods and services – basic foodstuffs, rents and public transport charges – are in many instances fixed and controlled by the authorities. Subsidies are often granted to ensure that the production of such goods does not come to a halt.

This runs counter to the promotion of growth in two respects: First, part of the increase in state revenue due to inflation has to be used for purposes of consumption and is thus no longer available for the purpose of increasing the production potential; and the high cost of incomes distribution via the state administration must also be taken into consideration. The high cost of the first incomes redistribution via inflation is followed by a second one which offsets the undesirable effects of the first one in part. Secondly, the investment propensity of entrepreneurs is curtailed in economic sectors of particular importance for supplies for the population and economic development. Investors will exercise restraint in the industries in which profitability is lowered by state measures and profit prospects depend on unforeseeable state decisions.

☐ State interference with prices thus results in fundamental changes in investment decisions and directs risk capital available for investment into economic sectors in which prices are not regulated and higher profits can be obtained. A disproportionate development of the economy and misdirection of capital are the consequence. If prices are manipulated by the state the money capital, which is extremely scarce in developing countries, will be used in directions which do not accord with government aims. Essential supplies to the population will fall off.

Changes in Investment Decisions

☐ In most LDCs the political and economic conditions are marked by a high degree of instability. Private investors will be deterred further if in consequence of the inflation the state authorities fix the prices, costs (eg: minimum wages) and conditions of production. This sometimes adds so greatly to the risk that money capital accumulated inside the country will be transferred abroad (flight of capital) or invested unproductively (e.g. by hoarding gold), that foreign investors will keep away and that, at best, quickly realisable investments such as speculative inventory holdings will be chosen.[5] For these reasons it is hardly possible

[3] See, among others, G. S. Dorrance, Inflation and Growth. The Statistical Evidence, in: International Monetary Fund Staff Papers, Vol. XIII, p. 82 ff.

[4] Before these considerations are dealt with it seems appropriate to eliminate from further consideration the case of temporary non-employment of reserve capacities due to cyclical causes, for it is of no topical interest for LDCs.

[5] Cf. J.-P. Wülbern, Zur Frage einer funktionsfähigen Wettbewerbsordnung in Entwicklungsländern (On the Question of a Viable Competitive Order in Developing Countries), Düsseldorf 1970, p. 48.

to follow certain advocates of inflation in LDCs who hope that the formation of real capital brought about automatically by inflation will, owing to its somewhat delayed effect on the capacity potential, lead to an increase in the supply of goods and act as an automatic curb on the money depreciation. Even if the state comes in as an investor to fill the gap, the result will not be greatly different because the state can usually replace only part of the lost private risk capital and many governments moreover tend to prefer big prestige projects with little capacity effect to a large number of smaller investments in which capital is tied down for short periods only and the effect on the capacity potential is greater.

☐ It is often overlooked that inflation impairs the efficiency of competition as a stimulant and medium of control, and in many LDCs it is in any case rather weak. What could be an important impulse for growth is thereby weakened, and there is consequently less need for lowering costs and improving performance.

☐ If a government tolerates or facilitates the money depreciation, balance of payments difficulties will arise in case the rates of exchange are fixed. If a currency is overvalued, realignment of its parity will normally not be undertaken often enough and fail to make a fundamental change. As a result imports will be artificially cheapened and exporting made more difficult. This undesirable effect will be resisted by means of export promotion, imports obstacles, foreign exchange controls and similar intervention. Such acts of state intervention and the associated risks cannot be foreseen by the enterprises any more than other repercussions of inflation, a fact which paralyses private initiative and deters investors.

Negative Effects on Savings

☐ Inflationary processes discourage voluntary saving and cause savers to seek safety in real assets certain to retain their value. Purchases of durable consumer goods for the buyer's own requirements which were to have been made later are often effected earlier, a fact which can only aggravate the imbalance between supply and demand and give an uplift to the rising prices. As against the hope that inflation-induced involuntary savings will promote economic growth there is the fact that voluntary saving will decline, and savers will invest their money abroad or take to forms of investment which have no effect on the capacity potential. This fact alone is in practice likely to largely offset the positive impulses of money depreciation on growth.

☐ Finally attention should be paid to the consequences of inflation for private capital exports from the industrial countries. It may be assumed that given certain preconditions inflation will stimulate the profit expectations of the entrepreneurs (debt repayment in depreciated money, lagging of wage and cost increases behind selling market prices). As however foreign investors in LDCs must anticipate incalculable drawbacks from inflation (e.g. through state interference with prices, minimum wage increases and restrictions on external transactions), the overall effect can hardly be expected to be favourable to investment and growth.

Whether inflationary processes are opportune from the point of view of growth policy can be satisfactorily judged only if secondary, tertiary, etc., repercussions can be assessed together with the primary effects on which attention is usually focused. It is true that the described consequences insofar as they concern state intervention do not automatically follow from induced or tolerated inflation. Experience however shows that the governments of many LDCs will react in the described manner. As there are quite a number of major factors obstructing growth beside those which may promote growth, it would, to say the least, be careless to rely on the preponderance of the growth stimulants.

Escalating Inflation Rates

It is nowadays accepted as undeniable that all economic subjects will after a certain transitional period adjust their dispositions to an unchanging rate of inflation. An equal inflation premium enters into the prices of all production factors and goods. Once this happens, it is no longer possible to derive gains from the lead of rising prices in selling markets over more slowly advancing wages and other costs, and the interest on capital includes a full offset for the annual inflation rate. For this reason high inflation rates do not result in automatic involuntary savings nor do they favour the investor to the disadvantage of the savers.

This then is another prerequisite of growth promotion by inflation. Inflation rates must obviously escalate, and trade unions and savers must not perceive the money depreciation and anticipate this escalation by demanding higher wages and interest rates. Only if both these conditions are fulfilled can the strategy of growth by inflation be successful. The limits of this conception are thus laid bare. Only for a certain time will increasing rates of inflation take trade unions and savers by surprise. Besides, there are limits to the depreciation of money which can take place in one year. Important functions of the money will be increasingly impaired if the rate of inflation rises continually. This also shows that for the longer

term inflation offers no promise of success as a development strategy.

That politicans and economists take such disparate views of the possibility of promoting economic growth by inflation is connected with their different assumptions concerning the response to money depreciation of private households and business enterprises. On the assumption that private households will give way to the money illusion even after prolonged periods of substantial inflation, that in fact they do not appreciate that the real value of the unit of money is declining, the conclusions are bound to differ from what they would be if the continual rise of the price level provoked swift defensive reactions. There is much to suggest that the money illusion will be more pronounced in LDCs, especially among the rural population which is still accustomed to a subsistence economy. The situation is different for the urban population which owing to its low real wages is hit hard by price increases. Its reaction to redistribution of incomes by inflation will probably be increasingly neuralgic. The rapidly growing urban population will in all probability gain more political weight in future and make growth promotion by inflation difficult.

There is a wide-spread view that inflation is a necessary accompaniment of economic development, in the countries of South America in particular. It is thought that an attempt to prevent the continual depreciation of money values would impede the requisite structural changes and intolerably retard economic growth. Inflation was being caused by exogenous factors including i.e. rapid growth of population and increasing demand for food combined with low flexibility of supply vis-à-vis changing prices, deterioration in the terms of trade, price increases due to increasing substitution of imports and repercussions of devaluations on domestic price levels.

Inevitable Inflation?

It is not possible here to deal with the arguments of the "structuralists" in detail.[6] Two points however may be brought out, namely that cause and effect are confused in some of the arguments by the structuralists and that too little attention is paid to a crucial growth factor, viz. the creation and safeguarding of an economic system which allows the full deployment of the existing productive forces.

That prices respond little to changes in the supply of foodstuffs is often due to traditional attitudes of the farmers and to land reforms which have placed agricultural land in the hands of people without sufficient entrepreneurial ability. To note this fact is no criticism of land reforms as such but of insufficient preparation of and advice for the new owners in regard to what are to them unaccustomed tasks. In many countries, including LDCs, the response of peasants to price signals is often amazingly strong provided they can count on a certain measure of price continuity and need not be afraid of state intervention with prices. This shows that the low price flexibility of supply is not an irremediable case of force majeure. The politicians concerned with economic affairs in LDCs will have to go further into the reasons for the slow response of prices to changes in supply and draw consequences for economic policy. Existing structures can very well be adapted to changes in the market situation. State intervention which has the effect of conserving existing structures will however have to give way to measures which encourage change.

A deterioration in the terms of trade does not necessarily provide grounds for inflationary processes in LDCs. The terms of exchange in international trade can deteriorate because of falling export prices in the LDCs. If such price-falls are due to a corresponding improvement in productivity in the production of the export goods, the LDCs will be able to purchase import goods at unchanged prices with no greater factor expense than previously. In that case there will be no inflationary effect. It should however be pointed out that many subsidies, export aids, import obstacles, acts of price intervention, price guarantees, minimum wage regulations, artificially depressed rates of interest for certain investors and tax provisions have the effect of impairing the adaptability of the economy and the mobility of the production factors, of frequently directing private initiative into wrong directions, of artificially lessening the need for cost reductions and thereby causing factor productivity in LDCs to improve more slowly than is the case in industrialised countries which may make the same mistakes though usually to a lesser degree. These are important causes of the deterioration of the terms of trade. If the responsible politicians, besides, pursue too quickly too many and too ambitious development objectives with small effects on the capacity potential, it need not cause surprise if there are high rates of money depreciation causing the detrimental effects on economic growth mentioned above. The fact that only modest rates of growth have been achieved in many LDCs, despite the inflow of considerable amounts of foreign aid over a decade or more and despite (or because of) high inflation rates, gives food for thought.

[6] Cf. R. de Oliveira Campos, Economic Development and Inflation with Special Reference to Latin America, in: OECD, Development Plans and Programmes, OECD Development Centre, Paris 1964, pp. 129-137.