Development Policy

Inflation and Economic Growth in LDCs

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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 inflation.

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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 (e.g. 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

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.