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ECONOMIC DEVELOPMENT - WITHOUT INFLATION?

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A fellow economist recently contrasted his colleagues employed by central banks and those employed by development institutes. Central bank economists, he said, find their greatest satisfaction in contemplating beautifully drawn curves which show the stability of the money supply, prices, etc. Economists in development institutes, he alleged, find their greatest satisfaction in contemplating plans for new and better roads, agricultural equipment, factories, etc. The satisfactions of both have a role to play in answer to the question which is before us today. May economic development of underdeveloped countries be secured without inflation?

Relation Between Economic Development and Inflation

By economic development we mean the process by which living levels are raised and productivity per man-hour employed is increased. Inflation can be defined for our purposes as a persistent and substantial upward movement of prices and money costs and a rise of money incomes which far exceeds the rise in real income. In considering the relationship between economic development and inflation, it is important to identify those aspects of the development process which give rise to the problem of inflation. The development process may create a continuing volume of effective demand for goods and services which exceeds at a rigid price level a country's capacity to supply such goods and services. The inflationary process is one means of resolving excessive demands upon productive output. It places upon the price system the whole burden of reducing effective demand in any given period to the volume of goods and services available.

The origin of the inflationary pressures associated with the development process is ordinarily attributed to the high volume of investment, whether

1/ This paper will be presented at the Second Meeting of Experts of the Central Banks of the American Continent, Santiago, Chile, December 2-17, 1949.

private, public, or both, required by a satisfactory development program. A high volume of investment is significant because it utilizes resources and produces consumer income without immediately making available additional supplies of goods and services to consumers. Furthermore, it is investment activity which is peculiarly adapted in the current institutional framework to financing by expansion of credit.

These aspects of the investment process mean that a higher level of investment, under conditions of full employment of resources, is likely to create higher levels of money income, with correspondingly increased pressures on available supplies of consumer goods and services, while at the same time attracting into investment basic resources used in the production of consumer goods. It should be recognized, however, that from a purely analytical point of view, the demands exercised by all sectors of the economy contribute to excessive demand, and it is the unrequited competition among all sectors for a limited volume of goods and services and for the basic resources used in their production, which is the heart of the inflationary process.

For the purpose of this paper we shall concentrate on the broad relations between inflation and economic development. We shall ignore many independent sources of inflation, of particular importance in the period since the beginning of World War II.

Major Variables

On the basis of this introductory analysis, it appears that the primary variables which determine the extent to which economic development involves inflationary pressure are the following:

Firstly, the volume of unemployed resources which could be drawn into the production of additional goods and services when effective demand reaches a higher level. Secondly, the level of investment expenditures, both private and public, which an acceptable economic development program requires. Thirdly, the volume of internal savings which the economy of the country generates. Fourthly, the availability of foreign credits for the financing of an import surplus during the earlier stages of economic development.

Although each of these factors is by no means independent of the others and although the strategic elements in the situation could be reformulated in other terms, it will be of interest to consider each of these four variables.

The existence of unemployed resources in the initial stages of a development program will operate to cushion the inflationary pressure generated by a higher level of investment expenditures. With a higher level of effective demand such resources can be drawn into employment with relatively small increases in the general level of prices. The extent of unemployed resources is important to an economic development program only in the short-run, however. Over a longer period, economic development is fundamentally a process whereby under-utilized resources are made more productive.

The identification of under-utilized resources is an important aspect of any development program and has an important bearing on the second variable cited above, the level of investment expenditures which an acceptable investment program requires. The transfer of resources to more productive employment within an economy is bound up with the question of the desirable level of investment expenditures. The formation of real capital may be a pre-requisite for effecting many of the transfers that are desirable. The greater the extent to which increased capital formation is a prequisite, the more intense the inflationary pressures generated by an economic development program. This can, of course, be put another way. The greater the extent to which increased capital formation is a prerequisite for effecting increases in productivity, the greater the cost of economic development in terms of its impact on the current level of consumption.

In much of the current discussion, it is asserted that a very high rate of capital formation is necessary to secure increased productivity. Although the necessity for a high rate of capital formation may be supported by reference to the record of those countries which have developed in the past at a rapid rate, it is by no means obvious that their experience in this respect is wholly relevant for the currently underdeveloped countries. A direct determination of the desirable level of capital formation can only be made after careful surveys of a country's material and human resources and a detailed study of the prospective increase in productivity or real income which would result from the execution of many alternative investment projects.

Some more general arguments, however, relating to the direction which the economic development of the underdeveloped countries should take, have a bearing on the level of capital formation. Dr. Prebisch has presented in his recent report for the ECLA, "The Economic Development of Latin America and Its Principal Problems" - an argument of great interest in this connection. Dr. Prebisch asserts on the basis of an alleged long-term deterioration in the terms of trade of the primary producing countries that the economic development of these countries is dependent upon more extensive industrialization. The fruits of innovations can be enjoyed by the now underdeveloped countries only if their economies contain important elements of industry, since the highly developed countries of the world have not passed on increased productivity resulting from innovations in the form of lower prices. To capitalize upon the application of innovations, the primary producing countries must be in a position to apply them in their own economies. I hope we shall have an opportunity to discuss this thesis during the course of the conference.

Another proposition which leads even more directly to the necessity for a high level of capital formation is found in recent economic literature. It is claimed that very substantial investments in underdeveloped economies are required in such basic sectors as transportation, power, irrigation, etc. Investments in such fields, it is claimed, secure widespread "external" economies. Their economic benefits accrue to the economy only after a considerable time lag and primarily through the operation of enterprises which are stimulated by the existence of low-cost transportation, electrical power, etc. In order to capitalize upon twentieth century productive techniques, it is necessary, according to this view, to have a wide range of complementary industries. Diversification, not specialization, is the means of economic progress. It is not simply a matter of incremental changes in the real capital structure of the country. A quick leap forward must be made in order to establish a basis for steady growth in the future. It is interesting to note also that, since the long-term economic benefits arising from the establishment or improvement of many basic industries cannot be easily taken into account by entrepreneurs seeking their own private profits, an argument is thus provided for state promotion or direct state participation in investments in such fields on a large scale.

Although there is no doubt some theoretical validity to the point of view discussed above, its implications in quantitative terms for the desirable level of investment in any given underdeveloped country are difficult to determine. Careful surveys will have to be undertaken in the underdeveloped countries to determine the extent of complementary benefits to be gained and the real cost to be incurred as the result of a coordinated investment program in basic industrial fields. In such calculations, it should be recognized that any substantial change in the industrial structure of a country, particularly a change which involves shifts in the population and the emergence of more-concentrated centers of population, requires large-scale investments in housing and public services. Such investments, while contributing to increased productivity and to a progressive increase in living levels, necessarily limit by their own magnitude the extent to which the economic base of any country can be rapidly changed. If this is ignored, an over-ambitious investment program may result, with a corresponding magnification of inflationary pressures.

Furthermore, there are certain obvious limits to a literal applicability of the diversification - industrialization hypothesis. In small countries with fairly limited natural resources, particularly, the concept of economic development must necessarily involve a considerable degree of specialization, with investments being directed first to improving productivity in fields closely related to the more traditional lines of economic activity. For such countries to realize the fruits of increased productivity may raise some problems, but these problems appear to be more surmountable than those involved in endeavoring to create an economy modelled after the presently more-developed countries.

There is thus considerable uncertainty surrounding the general arguments which point toward the need for a substantial expansion in investment in underdeveloped countries if economic development is to proceed at a satisfactory pace. In any case, however, it should be noted that even though a substantial expansion of certain types of investment may be necessary, the extent to which this exerts inflationary pressure is dependent upon the feasibility of restricting less essential investment. Such action in turn depends on the exercise of credit and budgetary controls, and other governmental measures, a subject which is reserved for later discussion.

The third variable previously cited affecting the extent of inflationary pressures is the volume of savings. Competitive bidding between the consumption and investment sectors of the economy is one of the primary characteristics of an inflationary process. The extent of such bidding is reduced if a relatively high volume of savings is generated by a given increase in real income. In other terms, the more income recipients are willing to restrict their consumption voluntarily during the development process, the less the magnitude of inflationary pressures resulting from the investment program. The determinants of the propensity to save in an underdeveloped economy are decidedly complex, and we cannot examine them here. However, it is often noted that, if during the development process the higher income groups reap the bulk of the increases in real income, the more likely it is that the savings-income ratio will be high. This assumes, of course, that such an income distribution does not have unfavorable implications for the composition of investment and the establishment of appropriate economic incentives. In any case, I think you would all agree that a development program depending upon an even more unequal distribution of income in any underdeveloped country poses problems which are not greatly different from those created in an inflationary situation.

The availability of foreign capital inflows is the fourth variable determining the extent to which economic development involves inflationary pressure. By permitting an excess of imports of goods and services over exports of goods and services, foreign credits absorb inflationary pressure originating in a high level of domestic investment. The role of foreign capital is being discussed in another section of our program, but it might be noted here that, from the point of view of the country from which capital is obtained, the inflationary pressure is increased, not absorbed. Whether the shift of such pressures to these more-developed countries from which foreign capital might flow is feasible depends upon a host of factors, the one of most interest in the context of this discussion being whether the country from which capital might flow is itself subject to intense inflationary pressures from other sources. When such inflationary pressures do prevail, and the prospective yield on domestic investments is favorable, there may be little opportunity for any one underdeveloped country to obtain a substantial inflow of private credit from abroad. On the other hand, when domestic investment opportunities in the more-developed countries are less favorable, the less-developed countries may offer considerable attraction to foreign private capital, particularly if profit opportunities there are maintained as a result of the development program and such special barriers to foreign capital inflow as exist are removed. The problem posed here raises some interesting questions for the role of private and public international capital in facilitating economic development which can best be discussed under another part of our agenda.

The Case for Inflation

A consideration of these various factors determining the magnitude of inflationary pressures in the economic development process has led many people to conclude that the future development of many Latin American countries can not be secured without a continuation of rapid upward movements in price levels. They point out the difficulty of securing and maintaining even moderate increases in the over-all level of investment when voluntary domestic savings are low relative to income and an inflow of foreign capital is difficult to secure. The chances of securing a better devised tax system, control over credit expansion, and a system of intelligible budgetary controls are held to be slim. In any case, the prospect of a rapidly rising price level is not so bad, they claim, since it does offer considerable encouragement to private investment. If exports become unprofitable with rising internal price levels, devaluation of the currency can be made, and in any case, domestic production, it is asserted, will increase as a result of promotional and protectionist measures and this will reduce the need for imports.

A Consideration of the Case

Can this superficially attractive case for economic development with inflation be accepted? It must be conceded that inflationary techniques in the primary stages of a development program may play a useful role in securing full utilization of resources and a generally higher level of investment, and in limiting the resources used for consumption.

In the early stages of a development program, unemployed resources may be brought into use by the higher level of effective demand associated with the inflationary process. Although prices and costs may rise, the real income of the community increases, making possible a higher level of investment. The full significance of the inflationary process in the initial stages of a development program is best appreciated by noting the problems that are likely to arise if inflation is completely eschewed. If before undertaking to promote a higher volume of investment the government must be completely assured that resources are readily and fully available, either the higher volume of investment may not be undertaken, or the measures taken to free these resources may themselves actually initiate a downward movement in employment and income. In the early stages of a development program, before there is full appreciation of the buoyancy of effective demand, there is a real danger that such measures as an increase in tax rates or a restriction of credit to certain sectors of the economy will have unplanned deflationary effects. Under such circumstances, an error in the opposite direction may well be justified.

While the inflationary process is of some use in moderate doses during the early stages of a development program, the benefits appear to be soon exhausted. Although the information which would permit us to form a more objective appraisal of the effectiveness of those economic development programs which have relied upon continuing inflation is difficult to mobilize, I should like to suggest two hypotheses:

(1) That the inflationary process is poorly designed to make really effective use of those resources that can safely be spared from consumption purposes;

(2) That the inflationary process as a means of securing a higher level of investment, both private and public, is a precarious social and political technique for the solution of basic problems of resources allocation and income distribution; partly for this reason it constitutes a serious barrier to the entry of foreign capital.

A substantial portion of the increase in investment occurring in inflationary development process is not particularly conducive to economic development. Many worthwhile investments may be undertaken, both under private and public auspices, but experience has shown that in most countries, the construction of luxury office buildings, apartments, and private homes absorbs a substantial portion of the increased investment. Reliance upon the prospect of a lag between price increases and cost increases to stimulate private investment is likely to lead to types of investment which bear little, if any, relation to development needs. The inflationary psychology permeates, furthermore, the basic expenditure decisions made by governmental authorities, and, there is no real appraisal of the real costs and benefits to be obtained from alternative courses of action, partly because in the inflationary process it becomes extremely difficult to estimate costs, and to assess benefits. With such a high proportion of resources that can be freed from consumption employed in non-essential investments, both private and public, it is often impossible to make prevision for those investments which are essential for economic development purposes. In particular, difficulties are encountered in providing housing for low income groups, such housing often being essential for securing the transfer of workers to more productive employment.

Furthermore, it soon appears that resources previously devoted to production for export are being diverted. To meet this situation, exchange depreciation may be resorted to, but it is found that in an inflationary environment it is extremely difficult to effectuate the necessary adjustments. Controls over imports, which may have been imposed to cushion the impact of rapidly rising money incomes on the balance of payments, have to be tightened, and it becomes increasingly difficult to import even the capital goods needed for the development program. Domestic inflation, even when temporary circumstances make possible a high volume of exports, may impair the maintenance of productive capacity in existing export industries and certainly makes very dim indeed the prospects for the establishment of new export lines. The long-run capacity of the country to earn the foreign exchange necessary for economic development is thereby jeopardized.

Thus, in allocation of resources to investment purposes, to general government services, and to export uses, the inflationary process is an inadequate and, at best, uncertain instrument.

Furthermore, continuing reliance upon inflation as a means of securing a higher level of investment creates serious social and political dangers. There can be no assurance that, if inflation continues, consumption will not be reduced below minimum levels. When private investment demands are subjected to few if any restraints, and when public investment decisions are made in an inflationary environment, it is easy to over-invest. Such over-investment may involve heavy sacrifices of consumption by groups having relatively fixed incomes. Even when over-investment is prevented for the most part, perhaps, by the action of organized groups who succeed in offsetting the effect of price increases on their consumption by securing wage increases, there is still a heavy cost in economic and social conflict. The increasing inequities in incomes, which emerge in an inflationary situation, add fuel to the flames of discontent.

The longer-run political implications of these developments constitute a serious barrier to the entry of private foreign capital, even when profit opportunities may be relatively favorable in an underdeveloped country. The fear of expropriation and generally unfavorable treatment to foreign private capital is to some extent attributable to the judgment that inflationary situations are politically explosive.

In addition, the inflationary process creates many specific uncertainties, particularly with respect to the remittance of earnings, the effect of which is to discourage the entry of private capital. International and national governmental agencies also have serious reservations in granting credits to countries relying upon inflationary processes for economic development.

The defects of the inflationary process - the dangers of over-investment, of misutilization of resources which can safely be spared from consumption, and of discouragement to foreign capital - suggest the need for alternative methods of achieving economic development.

The Means of Stable Economic Development

One such alternative method is the employment of a comprehensive system of direct controls. By using such controls, including allocation of materials and manpower and rationing of commodities to consumers, a nation could limit the level and control the composition of investment and determine the level and composition of consumption. In such a country even a fairly rigid price level might place no insuperable obstacle in the path of economic development. Although the elements of an anti-inflationary financial policy might play some part in such a country, they would presumably be subsidiary to the use of the direct controls.

It is, however, also perfectly clear that with comprehensive direct controls there are many economic, social, and political disadvantages which to many of us at least far outweigh the potential benefits. Detailed administration by the state of almost every aspect of economic life has implications for the character of political and social institutions which are familiar to all of us. Furthermore, even if a system of comprehensive direct controls in the abstract may be acceptable to some, it is politically and administratively not a feasible means of securing economic development in many of the underdeveloped areas of the world.

A second alternative, certainly more in line with our democratic ideals and concept of governmental responsibilities, involves the use of fiscal, credit and related measures, as well as certain limited forms of direct controls applied at strategic points. Such a program, oriented toward limited price increases, will attempt consciously to curtail effective demand within at least rough limits determined by the available productive capacity. This matching of effective demand against potential supply will not be as rigorous as in the case of comprehensive direct controls, nor as faulty as in the case of uncontrolled inflation.

In order to control effective demand, basic decisions must be made to promote only those investments most conducive to economic development and to establish within certain limits a ceiling on the total volume of investment, both private and public, and on the level of general government expenditures. Further basic decisions must be made regarding the appropriate level of private consumer expenditures. The work now under way in several of the Latin American countries, including Chile, Colombia, Venezuela, Mexico, and Peru, to construct a system of national accounts which will reveal in an analytically significant manner the composition of the gross national product should facilitate such basic decisions.

The implementation of these decisions will require discrimination in the choice of techniques. Improved budgetary machinery, including a more effective system of budgetary controls is absolutely essential. Credit institutions, both private and public, will have to exercise greater restraints and selectivity in their credit operations. We must develop more explicit criteria for guiding credit institutions; in this connection, a study of money flows in the economy, along the lines discussed in another paper presented here, should be extremely useful. Even among central bankers too much emphasis has been placed on the ambiguous distinction between "productive" and "nonproductive" credit. A credit policy designed to promote economic development must be based on distinctions which have some real meaning in terms of the functions actually performed by credit operations.

In an effort to influence the composition of private investment and to limit its total volume, some forms of direct controls may be advisable, and have already been used, in a limited fashion, particularly where import or exchange controls have been in force for balance-cf-payments purposes. Since a large portion of domestic investment in underdeveloped countries require imported capital goods, it is possible to influence the composition and volume of private investment by import controls. It must be carefully considered, however, whether the screening of private investment through import controls is the best available device. The more effective the screening effected through credit agencies, the less need there will be for the more direct devices. Furthermore, in one of the most important areas of investment - construction - imported goods are often not absolutely essential. In this field of construction particularly, the potentialities of credit controls have not been realized.

Fiscal policies also have an important role to play in implementing any ceiling on the level of investment. In deciding upon the means of financing government expenditures, including the public investment program, careful consideration should be given to the implications of alternative tax and borrowing programs. If government investments are to constitute a very large part of the total investment program, inflationary bidding for a limited volume of resources will be reduced by absorbing a larger portion of funds available for private investment, either through higher taxes or through borrowing funds which would otherwise be utilized in private investment. On the other hand, if the government investment program is a relatively small part of the total program, a larger portion of current savings may be left free.

The formulation and execution of an investment program along the lines indicated here presents some difficulties with respect to maintaining investment at a satisfactory level and preventing consumption from encroaching upon the resources needed for economic development. Cf course, if this anti-inflationary program, among other measures, induces additional foreign capital inflows, the current levels of both consumption and investment may be increased. In any case, under a well-coordinated program, a larger portion of the investment which is realized can contribute to economic development.

In some countries which have employed inflationary processes, an actual reduction in the over-all rate of investment may be desirable in order to secure an adequate level of consumption. Even in these countries, however, the immediate increase in consumption must be limited if the development program is to proceed at a satisfactory rate. Although it is difficult to substitute non-inflationary techniques designed to limit consumption for previously employed inflationary processes, it is by no means impossible. To rely in the early stage of a development program upon a quick increase in voluntary savings or a drastic increase in taxes as a method of reducing consumption below current levels is one thing. To rely at a later stage upon increased taxes and measures to promote individual and collective savings as a means of limiting increases in consumption is another. The former requires a measure of self-discipline and the emergence of a cultural-economic behavior pattern completely impossible in most underdeveloped countries. The latter, while difficult to achieve, has some real appeal, particularly when consumption levels have been precariously maintained in an inflationary process and when the anti-inflationary program is associated with clearly recognizable efforts to restrict investment to areas holding the greatest promise for higher living levels in the future.

One problem of special importance in calling a halt to economic development by inflationary processes deserves special mention. This is the problem of putting a stop to the wage-price spiral which often develops during inflation. Wage-price relationships must be established at a point which does not permit any substantial immediate increase in consumption but which does permit greater assurance as to the protection of basic consumption levels. This involves difficult technical, as well as political and social problems, which can only be resolved in terms of the basic institutional framework available in each country for the settlement of wage disputes and for the determination of wages. However, those who place great stress on the difficulties involved in getting wage earners to accept a wage contract which will not add fuel to the fires of inflation neglect the fact that wage earners are naturally reluctant to accept the promise of price stability, even if accompanied by an official price freeze in basic consumer goods, so long as the volume of investment is not brought under more conscious control. In countries vigorously and indiscriminatingly promoting economic development, resources available for consumption can be easily diverted, and under these circumstances such promises are meaningless, and we should not be surprised if they are recognized as such. With the volume of investment under control, one of the major obstacles to agreement on a more stable wage-price relationship will be removed.

In a very basic sense the answer to our question - can economic development be secured without inflation - rests on the feasibility of a politically and socially sanctioned decision with respect to the level of investment, a decision which will permit a high, though controlled, volume of investment at the same time that it permits the maintenance of basic consumption levels and provides for their steady growth. The availability of appropriate instruments which can be applied effectively in credit, fiscal, and other fields may go far in determining the feasibility of such a decision, but whether such a decision can be made is obviously dependent on many other factors. The outcome may determine not only whether the underdeveloped countries can be developed without inflation but also whether they can be developed at all.