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Asian Views on Inflation and Economic Development

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Asian Views on Inflation and Economic Development

One of the most spirited debates of the post-war period has been concerned with the relationship between economic growth and inflation. Both the developed and the underdeveloped countries have become involved in the problems of whether inflation can promote economic growth, whether inflation is a necessary concomitant of attempts to achieve growth, and how much inflation an economy can safely absorb. If it should be true that inflation can be a contributor to economic growth, traditional monetary and fiscal policies, which attempt to counteract inflationary pressures, may have to undergo extensive revisions.

The case against the use of traditional or orthodox monetary policies by underdeveloped countries has frequently been associated with Raul Prebisch, the Secretary-General of the Economic Commission for Latin America. According to Prebish,1/ inflation is a product of structural disequilibrium within the underdeveloped countries. This disequilibrium is caused by the extreme vulnerability of their internal economies to changes in foreign demand for their exports. In the upturn of the business cycle, there is a strong demand for the exports of the underdeveloped countries. Increased exports enable these countries to expand imports needed for economic development programs. However, when the cycle is reversed, exports fall off, but there is still a demand for completing already started projects as well as for initiating new ones.

In this situation, according to Prebisch, a monetary policy designed to curb the resulting external trade imbalance by restricting credit would slow down domestic economic activity and hence retard progress toward economic development. On the other hand, the expansion of credit to offset reduced economic activity at times of declining exports would further economic growth. Together, with a vigorous policy of import substitution, this would make these countries less vulnerable to changes in the demand for their exports and consequently, in the long run, less in need of resorting to inflation to maintain economic activity. Thus inflation is regarded as a sort of necessary evil, which is preferable to the stagnation brought on by a monetary stabilization policy.

Another advocate of the use of inflation to promote development is Professor W. Arthur Lewis.2/ Lewis believes that underdeveloped countries are characterized by a surplus supply of labor which can be mobilized for creating capital goods by using the monetary pump. Money creation would finance the employment of surplus labor in the production of capital goods. As capital is being created, there would be a price rise since the newly employed workers would enlarge the demands on the existing stock of consumer goods. However, prices would receed as the output of the newly created capital is put on the market. Thus, inflation for the purpose of creating productive capital is regarded as being self-destructive.

1/ Economic Bulletin for Latin America, VI, No. 1, March 1961, pp. 1-25.

2/ "Economic Development with Unlimited Supplies of Labour," The Manchester School of Economic and Social Studies, XXII, No. 1, January 1954, pp. 139-91.

A third pseudo-Keynesian justification of inflation is based upon a supposed lack of effective demand in the underdeveloped countries. Accordingly, the lack of demand inhibits the activities of entrepreneurs and investors and results in unutilized factors of production. An inflationary policy, it is believed, would increase the demand for goods and would induce additional resources to be drawn into the economy. This would expand the countries' productive potentials. This third reason focuses on the side of demand as a reason for advocating an inflationary policy, whereas the Lewis argument focused on the supply side.

Asian views

The belief that inflation is desirable or necessary for economic development has been steadily losing ground in the Asian area. Asian thinking has been greatly affected by the experience of those countries which had adopted inflationary policies and suffered as a result--countries such as India, Pakistan, Ceylon, Korea, and Indonesia. The area's views on the merits of inflation are best depicted in the documents of the Secretariat of the Economic Commission for Asia and the Far East (ECAFE), a United Nations organization located in Bangkok, Thailand. They show a most marked change in attitude towards inflation over the years.

It should be noted at the outset that ECAFE generally[3] has realized the adverse effects on economic activity which a prolonged inflation could inflict; e.g., lessen confidence in the currency, encourage hoarding of goods, cause mal-investments, and worsen the balance of payments. Up to present, ECAFE has warned its member countries of these and other ill-effects. However, ECAFE's views have changed significantly over the years as regards the question of whether some adverse effects of a mild or "creeping" inflation are the price which a country must pay if it is to develop.

Up to 1956, ECAFE documents supported the position that inflation was necessary or desirable for economic development.

In the 1951 ECAFE annual Survey we find the following:

> "...economic development at the rate which is essential for maintaining and increasing standards of living cannot occur unless a very much accelerated rate of investment takes place, and this is bound to generate a certain amount of inflation."[4]

And in 1952:

> "There is a unique correlation between changes in the price level and capital formation: when prices are falling, capital formation is low; when prices are rising capital formation is high... the political dangers of allowing an economy to stagnate may in some cases be greater than the political dangers of inflation...

3/ In one exception, it was stated that there are circumstances where it would be entirely right to finance a large capital program by inflation even though prices rose considerably. Economic Bulletin for Asia and the Far East, III, January - June 1952, p. 8 (Hereafter referred to as Economic Bulletin).

4/ Economic Survey of Asia and the Far East: 1951, p. XXIV (Hereafter referred to as Economic Survey).

"in a private capitalist economy, inflation aids the process by which net saving is increased from say the 5 per cent level towards the 15 per cent level...some inflation is not merely tolerable but desirable, in so far as it is desirable to step up private investment... some inflation may foster economic development by providing greater incentives to, and a source of finance for, greater private investment."5/

The 1953 Survey also contained similar beliefs.

Such views were partly the result of the above economic theories, and their manifold variations, which justified the use of inflationary policies. However, the theories by themselves would not have exerted such an influence were it not for the very backward economic conditions which prevailed throughout the Asian area.6/ Low levels of capital equipment, labor productivity, and crop yields combined to hold incomes at very low levels in comparison to those prevailing in Western Europe and the United States. The need for rapid economic development was so pressing that it was considered most imperative to marshal all instruments which might possibly further economic growth. Inflation was one such instrument.

Given less urgent need, the governments of the Asian countries could have studied and investigated many policies, before selecting those considered to be most appropriate for spurring economic growth. However, the already very low standards of living and the population pressure precluded the more rational approach. Asian governments were intrigued by the theoretical justifications for inflation and its relatively quick results, as compared to the rather unglamorous orthodox monetary policy, and gave it their whole-hearted support.

However, experience, that unyielding gravedigger of many seemingly wholesome theoretical schemes, has shown the dire economic consequences which followed inflationary policies. Throughout the Asian area, inflation has brought in its wake the rapid drawing down of international monetary reserves, capital flight and overvalued exchange rates which have necessitated a tightening of trade and foreign exchange controls, the encouragement of speculative investments, the imposition of restrictions on prices of domestic goods with a consequent disincentive effect on domestic production, and - to the woe of the planners - the disruption of economic plans. The inflationary financing of budgetary deficits was responsible for the severe economic difficulties which occurred during India's second five-year plan (1956-61) and during the years preceding the institution of the Ayub regime in Pakistan. It is currently responsible for the economic deterioration in Ceylon and Indonesia.

The ECAFE Secretariat, in examining the experiences of its member countries, has developed an increasing awareness of the perverse influence of inflation on economic growth. The growing strength of ECAFE's conviction about the necessity for monetary stability is indicated by the following excerpts.

5/ Economic Bulletin, III, Nos. 1-2, January - June 1952, pp. 3-12.

6/ Excluding Japan.

In 1957, ECAFE stated that

> "---it is generally recognized today that inflation is one of the worst enemies of economic development."7/

In 1958,

> "The real task of monetary policy in a developing economy is to permit, on the one hand, such credit expansion as is necessary for economic development and on the other to keep it within the limits so as to ensure that inflationary conditions are not allowed to develop."8/

In 1960,

> "---the newly developing countries cannot think of growth in continuing inflationary conditions---(they) naturally tend to lay primary emphasis on development goals, but are forced to pay heed to considerations of stability by the logic of economic circumstances."9/

In 1961,

> "---the rate of saving should be compared with the planned rate of investment. The gap in savings, if any, may have to be filled by deficit financing, provided such action can mobilize real resources without undue price inflation or balance of payments difficulties. Otherwise, the planned investment rate may have to be revised downward."10/

In its latest Survey of Asia and the Far East, the ECAFE Secretariat unequivocally came out against inflation, both the large-scale and "creeping" varieties.

> "All evidence clearly shows that large-scale inflation is detrimental to growth...(it is argued that) a moderate rise in prices, if it could be kept moderate, fosters, rather than retards growth ---(but) not much weight can be given to these arguments within the ECAFE region."11/

It should not be thought that ECAFE's prescriptions have gone unheeded. Most countries of the region have come to regard inflation in a very different light than when they embraced it in the early and mid-1950's. A comparison of the current five-year plans of India and Pakistan with their earlier ones reveals the changed attitude towards inflation. Indeed, at the recent annual Bank-Fund meeting, the Indian Finance Minister stated that

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7/ Economic Bulletin, VIII, No. 1, May 1957, p. 17.

8/ Economic Bulletin, IX, No. 3, December 1958, p. 27.

9/ Economic Survey: 1960, p. 105.

10/ Economic Bulletin, XII, No. 3, December 1961, p. 17.

11/ Economic Survey: 1961, p. 41.

"Inflation is no answer to the inadequacy of real resources. In no case can it be a substitute for effective mobilization of savings for investment---financial or monetary stability is necessary but not a sufficient condition for development."12/

The more that people in the less developed countries realize the necessity for monetary stability, the more will these countries be able to focus their attention on the real obstacles to economic growth.

The inadequacy of the theories for inflation

Thus far, we have noted a few of the theories which have been used to justify inflationary policies and have indicated the Asian area's acceptance and latter disillusionment with these policies. The question naturally arises as to why the theories have proven to be so inappropriate among the underdeveloped countries of Asia.

The Prebisch argument of structural imbalance centers upon the sensitivity of the underdeveloped countries to changes in exports brought on by the business cycle. However, to refer to a country as imbalanced because of a large dependence upon exports for purchasing needed imports and for generating domestic incomes, would be to classify almost all countries of the world as structurally imbalanced. Even in such large countries as the United States and India, exports and balance of payments considerations are important economic elements. The so-called "dependence" upon exports enables countries to have higher real national incomes than otherwise; that is, than if there were no trade between countries. Exports offer countries the opportunity of procurring goods not available domestically, or produceable at higher costs than in other countries. Indeed, a country which attempts to lessen its international trade by the development of all types of import substitute industries, regardless of cost, is the one which is structurally imbalanced. Not only do such industries divert resources from more productive uses, but, often unrealized, they actually increase the import needs of the country---imports of raw materials, equipment, and replacement parts, as well as imports the demand for which is generated by the higher incomes received by the people employed in these industries. They thus ensure a continual imbalance in the country's external accounts.

Moreover, the fact that exports are often inadequate in relation to the demands for foreign currency is not due solely to the business cycle; i.e., to changes in foreign demand. Exports are dependent upon a multitude of factors and it is most difficult - if not impossible - to assign to any one factor the role of key determinant. The internal economic development process itself often tends to make the level of exports inadequate by enlarging import needs - for capital goods, materials for their domestic production, materials for the production of consumer goods, fuels, etc. Also increased domestic incomes tend to divert to internal consumption goods and materials formerly exported. This is true even in the case of exporters of primary commodities. For example, the postwar declines in sugar exports from Indonesia and oilseed exports from India are associated with the large increase in home consumption. Another influence on exports

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12/ "Statement by the Hon. Morarji R. Desai, Minister of Finance and Governor of the Fund and Bank for India, at the Fund's Annual Discussion," Press Release No. 66, September 19, 1962.

is the appropriateness of the exchange rate. The more the rate is overvalued, the less incentive do producers have to sell their products abroad, especially since their exports must be of good quality and able to compete with products of other countries. Sales in the expanding domestic market are very often free of foreign competition due to severe import restrictions and thus can be highly priced and of shoddy quality.

A very illuminating empirical study on the relationship between exports and domestic inflation has recently been completed by Miss Gertrud Lovasy of the International Monetary Fund. Miss Lovasy found a strong negative correlation between the degree of inflation and the growth of exports.

> "(Between 1953-59), the exports of countries with relatively mild inflation rose, on the average, by some 27 per cent, against a 35 per cent increase in those of stable countries. Exports of countries with strong inflation, however, remained on the whole virtually unchanged."13/

Inflation holds back exports by causing an overvalued exchange rate and by otherwise increasing the attractiveness to producers of the domestic market relative to foreign markets. A policy advocating inflation would actually stretch out the time until the country would become able to pay for its import requirements out of its own resources. Thus, when the underdeveloped countries are confronted with external trade imbalances, they should seek the basic causes involved and concentrate their remedial measures on these causes. Since domestic inflationary pressures are often a significant factor influencing the trade account, a policy of monetary stabilization is often the correct prescription.

Even in those cases where exports are retarded by the downturn of the business cycle, an inflationary policy is still inappropriate. The most prudent policy is one which takes into account the cyclical movements. During the upswing, not all foreign exchange earnings should be spent on imports. Some should be husbanded for the times when exports fall off cyclically. To regard the need for imports as so great that no foreign exchange can be put aside and then to blame the resulting economic difficulties on variations in exports is an example of mistaken identity. The real villain is the inadequate supply of foreign exchange, in relation to the demands made on it. The situation is not improved by unwisely utilizing the scarce supply.

Prebisch indeed sets up a "straw man" by comparing an inflationary policy which maintains economic activity and domestic incomes, to a stabilization policy which causes a contraction of activity and incomes. He assumes that stabilization means stagnation, and that inflation is equivalent to dynamism. Naturally, given such a comparison inflation would be the preferred policy.

Ignored are inflation's adverse effects on the balance of payments, its perverse effects on the development of an efficient structure of production, and its inverse effects on the level of private savings.

13/ "Inflation and Exports in Primary Producing Countries," Staff Papers, IX, No. 1, March 1962, p. 37.

Having noted the disruptive effects of inflation on economic development, a few words are in order in support of a monetary stabilization policy. Such a policy, it should be noted, does not mean that the money supply cannot expand or that credit creation cannot occur. It does imply that such expansion be held down to the increase in production plus the increased demand for money from the extension of the monetized sector of the economy. As a result, there would be no undue price rises or undue drawing down of international monetary reserves in order to purchase imports and keep prices down. A policy of monetary stabilization prevents firms from obtaining profits simply by selling at inflated prices, and thus forces them to keep costs down, quality high, and be adaptable to changes in technology and consumer demands.

Japan's experience is illustrative of the beneficial effects of a monetary stabilization policy. Up to 1949, the country was beset by severe inflationary pressures. Then a 9-point stabilization program was adopted and strenuously followed. One result was a dramatic reduction in production costs and improvement in the quality of goods. This program laid the foundation for Japan's rapid economic development, which has been the envy of all Asia.

This leads to the difficulty with Lewis' argument for utilizing surplus labor by promoting inflation. The chief problem in economic development is not that of simply making work. If this were all that were required, the task would be simple. Cheops was a great work-maker, but he was not much of a promoter of economic development. The same is true of inflation. A country can get into very serious difficulties by marking work that is uneconomic. The workers in such jobs are by definition not producing enough goods or services to offset the increased income generated. This means that indirectly they are really being subsidized by the more productive workers in the economy. This in itself may be a drag on the economy, but what may be more serious is that in the inflationary situation that is created there is likely to be a general downward pull on productivity. Management may be lax and the workers themselves are likely to be less interested in exerting their best efforts. Since maximizing productivity is the key to increased output, savings and the maintenance of a competitive position in world markets, the deleterious effects of relying on inflation to create jobs are easy to see.

The problem of finding more efficient use for the unemployed and underemployed labor of the underdeveloped lands cannot be solved by the simple device of making work and printing money to pay for it. In the first place, there is probably less surplus labor than it sometimes appears. Light work and leisure are often preferred to the rigors of heavy work and regular hours. The climate in many of the underdeveloped countries is conducive to this attitude. Many people who might be willing to work more intensively are discouraged from doing so by a social organization which causes income to be shared with relatives. In agriculture, the apparent excess of labor is often only a seasonal phenomenon. There may be real shortages of workers in the busy seasons, and in the absence of large numbers of migratory workers, these seasonal needs have to be met by keeping on the land workers who are superfluous much of the time.

What is needed is a change in social and cultural attitudes and the extension of technical training to make effective use of manpower. Such changes would be greatly aided by a stable level of prices, which would help prevent a decline in the amount of goods which people could purchase out of their wages. Inflation and a reduced purchasing power greatly discourage people from altering their set social and economic ways. Inflation is thus a most ineffectual weapon for utilizing the seemingly surplus labor of Asia.

The third theory on the stimulating effects of inflation on the demand for goods and, thereby, on production is also inadequate. The problem of the under-developed countries of Asia is decidedly not an inadequate demand for goods. Although an enlarged money supply might be useful for getting a developed country out of a recession, such a policy will merely bid up prices when applied to the underdeveloped countries. The difference between the effects of this policy in developed and under-developed countries is due to the existence in the former of unutilized resources which can be put to work by stimulating domestic demand. In the underdeveloped countries, there are not large amounts of unutilized resources which can be drawn into production by merely expanding money supply. An inflationary policy would increase the demand on already scarce resources and therefore cause prices to rise with little expansion in output. Thus, the pseudo-Keynesian prescription is inapplicable to the economic conditions of the underdeveloped countries, as ECAFE has noted:

> "In Asia, generally, it is not inadequacy of demand that keeps supply at relatively low levels, and excess demand is likely to damage supply by drawing away productive resources from activities that promote growth towards consumption and speculation."14/

Conclusion

The theories justifying an inflationary policy have proven to be most inappropriate for Asia, partly because of the special social and economic conditions of the Asian area. The main reason, however, is the inadequacies of the theories themselves.

The debate on the efficacy of inflation for economic development has taken a sharp turn in favor of those advocating monetary orthodoxy. ECAFE has become aware of the adversities of inflation, large-scale and "creeping," but there are still some who refuse to face the facts. Experience is a great chastener, but in order to be effective, it must be studied. Too many underdeveloped countries enthusiastically undertake programs, unaware that these have already been proven to be disastrous elsewhere. By examining the adverse experiences of those member countries which used inflationary policies, ECAFE has changed its earlier views on the benefits of inflation for economic growth, and in its writings has sought to dispell the remaining vestiges of ignorance on the results of inflationary policies.

14/ Economic Survey: 1961, p. 41.