CHAPTER 1.

The object of the present study is to investigate the relationship between inflation and economic development with special reference to India. A brief review of inflation theories as formulated in the context of developed and less-developed countries is undertaken in this Chapter to explore similarities and dissimilarities of the inflationary process as between these types of economies. Certain ideas regarding the inter-relationship between inflation and economic development are presented which may be later used in a more systematic manner in framing hypotheses.

Inflation has been defined in many ways. Perhaps the most comprehensive definition is one provided by Turvey. He calls inflation "the process resulting from competition in attempting to maintain total real incomes, total real expenditure, and/or total output at a level which has become physically impossible, or attempting to increase any of them to a level which is physically impossible".

As explanations of inflation, "two positions were rival claimants to the title of orthodoxy" before the Second World War. The Quantity Theory of Money attributed price level changes to changes in the quantity of money. The Keynesian explanation stressed the level of national expenditure as the main determination of the price level, a rise in expenditure leading to an inflationary gap after the attainment of full employment.

The Post-war period has witnessed theoretical extensions of these two basic positions. The extensions mainly relate to the expenditure approach rather than to the Quantity Theory approach. For the purpose of our study, it is not necessary to examine the different models of inflation. It has, however, to be stressed that though the different models identify different factors as initial or fundamental sources of the inflationary pressure and differ in their emphasis on the links in the mechanics of inflation, certain features of the inflationary process have relevance for all of them. Thus the emergence of inflation may be attributed to the growth in the stock of money, rise in the level of aggregate demand, demand shifts, cost-push etc., but it is generally believed that the continuance as well as the intensity of the inflationary process depends on the interaction of these elements to a considerable extent.

Inflation continues until the excess of the conflicting claims for shares in the real national product over the actual output is somehow reduced or otherwise reconciled. The speed of the inflationary process depends greatly upon the reactions of the different income and spending groups to the initial inflationary shock. "If there are few reactions, and if these are delayed or are not very vigorous, inflation will proceed slowly and will not go much beyond the initial shock. If, on the other hand, reactions and successive 'reactions to reactions' are numerous, rapid and vigorous, the resulting inflations can be explosive."

The analysis of inflation in less developed economies must take into account the differences in their structure as compared with the

developed economies. Even though changes in the stock of money or aggregate demand have to be stressed in the explanation of the inflationary phenomenon in such countries, the character of the inflationary process is governed by factors unique to such countries. A fundamental difference arises from the predominance of the agricultural sector in such economies which imparts a high degree of inelasticity to the supply of output in the short run. Often these countries exhibit great dependence on external events because of the fact that a few primary products account for a high proportion of exports as well as domestic production. The influence of trade union organisations on the price level is also limited in contrast to the developed countries. Because of a poor growth in the domestic capital goods sector, the rate of investment in such countries is also limited by the ability to finance imports of capital goods.

Inflation in underdeveloped countries is more due to structural reasons than cyclical. While low levels of per capita income and productive efficiency characterise underdeveloped economies, the national income is largely derived from subsistence farming. The industrialised sector is small, exports are relatively undiversified and mostly relate to primary products while capital resources, technical skills and entrepreneurial abilities are scarce. Further, financial institutions and markets tend to be rudimentary. The narrowness of financial markets not only impedes the effective mobilisation of savings but also substantially restricts the scope of operation of the credit policy. In an environment where the expectation of rising prices exists, capital market is even less able to perform its economic role since its capacity to influence self-investment
decisions of economic units is considerably damaged.4

One of the main causes of inflation in underdeveloped countries is that the investment effort which is regarded necessary to raise production efficiency to a desired level is usually far in excess of what is feasible on the basis of available savings. Capital accumulation is retarded because institutional saving in these countries is in its embryonic stage and the extent of monetisation is relatively low. Hence governments in such countries very often resort to inflationary savings by the creation of new money either through deficit financing or expansion of bank credits.

The vulnerability to inflationary pressures stems from the supply side as well due to its inelasticity and a rigidity in the production structure. Output is unresponsive over the short period to an increase in demand. On the other hand, with a slight increase in demand, prices rise almost instantaneously. In an underdeveloped economy, an early inflation takes place firstly because, in the initial stages, an increase in money income strikes against a limited stock of consumption goods and, secondly, the supply of factors of production is less than perfectly elastic. Although an initial investment may lead to higher output in the very short period, the secondary and tertiary effects of such investment are negligible. Further, a high propensity to consume leads to increased self-consumption, reduced outgoes to the market, and a rise in prices result.

Finally, unlike in a developed economy, any increase in investment does not

subsequently lead to an increase in investment because disguised unemployment is not as responsive to effective demand as unemployment is. Further, poor distribution channels and the inadequacy of transportation facilities in these countries aggravate the problem of maladjustment to a still greater extent.

In addition to these basic causal factors, there are some supplementary factors that tend to accelerate the intensity of inflation. One such element is the special sensitivity of domestic incomes and prices to export receipts. Sustained increases in export prices generally lead to an immediate swelling of the domestic money supply causing in turn a rise in demand for goods, an upward rise in the domestic price level and increasing pressures on imports. With a steady rise in the import bill, the balance of payments deteriorate, foreign exchange reserves gradually run down and it becomes difficult to overcome the shortage of raw materials and accessories which are mainly imported from abroad. This in turn acts as a constraint upon the elasticity of output in the short run.

The fiscal mechanism often proves quite inadequate in such countries. The regressive tax structure and its dependence on specific rather than ad valorem taxes generally results in a tendency for budgetary receipts to lag behind the rising cost of government services during periods of advancing prices. Moreover, budget deficits, on the other hand tend to widen, rather than to narrow, during such periods. The banking system cannot be expected and often is not permitted to counteract the inflationary pressure arising from a budget deficit by such means as would, in effect, run counter to the Government's policy.

There is, however, a "pressure" school of economists who maintain that a moderate rise in prices fosters rather than retards growth. It is argued that certain pressure of aggregate demand pulls aggregate supply nearer to a maximum rate of growth and that, in particular, the pressure will be greatest upon items for which demands are strongest so that their supplies could be increased as quickly as possible.

It is very often noted that inflation creates money income where little or none existed previously. This is supposed to stimulate the movement of previously under-employed resources, notably labour, into more productive employment. Insofar as these resources were previously lying idle, creation of new monetary resources would raise income and expedite mobilisation of physical resources at least up to the point where bottlenecks in production begin to cause a reduction in efficiency and an undue rise in prices. Where the physical resources are not readily available, such an investment policy may lead to industrialisation but accompanied by a price inflation that would reduce the real purchasing power available to other sectors of the economy; in other words, by bringing about a reduction in consumption which was difficult to contemplate in view of the low levels already prevailing.

Not much weight can however, be given to these arguments. Critics maintain that while some advanced countries even suffer some "normal" degree
of unemployment, the reasoning is far from conclusive that effective demand will stimulate a proportionate growth of aggregate supply in Asia. Generally, it is not inadequacy of demand that keeps supply at relatively low levels. An excess demand is likely to damage supply by drawing away productive resources from activities that promote growth towards consumption and speculation. 8

Again, in most underdeveloped countries, the alteration in the distribution of income and resources that accompanies inflationary investment is unlikely to generate additional savings to the desired extent 9. Thus inflation, from the point of view of development, takes on the character of a functionless rise in prices. In a large and prolonged inflation there is not likely to be any substantial pool of unused resources so that a continued increase in demand will soon result in excessive aggregate demand and will manifest itself either in a rise in prices or in a balance of payments deficit 10.

It is difficult, however, to establish criteria for the best allocation of investment. The character of investment expenditure, with respect to both industry selection and choice of production techniques will be decisive in determining whether a given volume of investment contribute as much to development as is possible. But the flow of resources effected by an inflation will be not only in excess of, but also partially inappropriate to the flow of demand in stipulated condition. 11(a) In the current

8. ECAFE Report, P-4.
literature on economic development, dis-equilibrium-creating disproportionalities that may arise from imbalances between different sectors have been assigned a central role in arresting growth. Conceptual disequililibria are considered distinct from self-correcting dis-proportionalities. Inflation is an overall source of bottlenecks. In so far as it reduces international disequilibrium of the bottleneck-creating type by directing investments into certain channels and away from others, it reinforces the factors which give rise to a low marginal efficiency of capital.

Inflationary gains in promoting economic growth are of illusory significance once it is considered that such gains are small in real measure, irrationally distributed over the economy and unsustainable. Economic waste and social inequalities gradually develop. The rise in production and the lag in wages that accompany the inflationary process further aggravate the maldistribution of income and intensify existing gaps in the economy. The claim that such a process would raise savings is difficult to justify for, any additional savings that could be obtained by transferring income to the high saving group demands a large amount of real income to be shifted from the low saving group; the reason is that only a part - and during inflation a declining part - of increment to profit is saved, the remaining being spent on consumption.

The truth is that the impediments to a higher rate of industrial growth are real and are not likely to be overcome merely by monetary devices alone. While monetarists call for orthodox prescription of restraining demand by the exercise of monetary and fiscal discipline, the structuralist position leans to the supply side of the problem and stresses the need for social and economic reforms in order to rectify basic structural imbalances. It is argued that inflation "cannot be explained as something divorced from the economic and social maladjustments and stresses. Anti-inflationary policy must be an integral part of development policy." Economic development calls for continuous changes in the production structure as well as in the pattern of income distribution.

A favourable change in economic conditions opens up newer opportunities for consumption or investment which when they exceed the genuine resources available, precipitate the inflationary process.