The existing literature on the relationship of inflation and economic development reveal that there exist divergent views on the subject and it is difficult to be precise about anyone of them. The varying degrees of price rise is likely to produce different effects upon the economy since the mix of factor proportions and the degree of mobility assumed in a given model may not hold good in other models. Hence there is likely to be dissimilarities in results for both developed and under-developed countries. A few probabilities in this regard have been indicated in the first chapter. An attempt has also been made to study the working of the economy under inflationary conditions in Chapter II, with Japan and some of the Latin American countries. It has been found that although some special circumstances prevailed in Japan that particularly acted in favour of ensuring a high level of economic growth amidst inflation, the group of Latin American countries studied in this context tends to confirm the belief that inflation, broadly speaking, is not conducive to economic growth. This has been so for quite a number of reasons cited earlier.

The issue has therefore been to examine the relationship of inflation and economic development and, in the present case, with a particular reference to the working of the Indian economy under the three Five Year Plans. For the sake of analytical convenience, a set of hypotheses were formed on the basis of our case studies of the countries covered in Chapter II. These hypotheses may be briefly reiterated here. First, that relatively high

* Vide Chapter III.
<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>PERIOD</th>
<th>ANNUAL COMPOUNDED RATE</th>
<th>Inflation (a)</th>
<th>Growth (b)</th>
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a) Percentage rise in cost of living index.

b) Percentage rate of increase in National Income deflated by cost of living index.
rates of price rise are likely to be associated with relatively low rates of growth and as a concomitant of this phenomenon, a persistent balance of payments problem is usually accompanied with a relatively high rate of inflation. Secondly, a shift in the pattern of distribution of income by itself is not a sufficient condition for generating an adequate quantum of saving required for the purpose of accelerating the tempo of development of the economy. Thirdly, a change in the intersectoral terms of trade resulting from a deliberate policy of emphasising investment in industry in preference to agriculture may cause an unfavourable impact upon the growth of saving in the economy. Fourthly, inflation affects economic growth through a shift in the pattern of investment resources and activities because the return on real capital investment is adversely affected. Finally, the wage-price relationship is significantly affected during the process of inflationary price rise so that the scope for real capital formation in the economy becomes limited and the volume of real investment cannot grow.

The experience of the working of the Indian economy has been broadly set out in this background. In Chapter IV, the trends of economic development in the period commencing from the beginning of the fifties and ending in the mid-sixties are studied. The behaviour of different indices like balance of payments, saving-investment, the inter-sectoral terms of trade and so forth are observed and it would be now our endeavour to see how far we have been able to test the set of hypotheses formulated earlier in the light of the experience gained from the working of the Indian economy.

The contention that lower rates of economic growth are likely to be associated with higher rates of inflation has already been set out in Chapter III. The principal generalization of an I.M.F. study is that
countries where prices advanced moderately or not at all from 1950 to 1957 experienced rates of economic expansion which are by and large steady and which variously clustered around an annual average of close to 6 per cent. In contrast, countries which sustained inflationary pressures that developed during this period showed widely varying and somewhat sporadic growth; the average rate of growth ranged from less than 1 to more than 7 per cent with an average of about 4 per cent for the whole group (vide Table 1). The I.M.F. Report points out, "the evidence suggests that the rate of growth was higher when the rate of inflation was lower". The contention will be amply supported by the growth trends of the Indian economy during the three Plan periods.

Judged by the trends in national income, the compound rate of growth for the economy as a whole during the fifteen years of planning was a bare 3.3 per cent per annum. The per capita real income during this period has grown very slowly, i.e., only by 13.2 per cent or 1.21 per cent per annum whereas the wholesale price index has risen by 36.9 per cent or 2.65 per cent per annum. During the First Plan period an average growth rate of 3.5 per cent per annum at constant prices went pari passu with a fall in prices by almost the same percentage over 1950-51. On the other hand, on the basis of a ten-year working period from 1955-56 to 1965-66, the per capita income increased only by 8.7 per cent or 0.87 per cent per annum whereas the wholesale price index went up by 78.5 per cent or 7.85 per cent per annum.

1. Fourth Five Year Plan, A draft outline, PP-419-430.
On reviewing these trends, the hypothesis tends to be confirmed that high rates of economic growth are unlikely to be associated with high degrees of inflation.

The other part of the hypothesis relates to the close association of inflation with balance of payments difficulties. One could expect that a relatively high rate of inflation would be usually accompanied with a persistent balance of payments problem. During the First Plan period, the Indian economy also underwent a period of relative monetary stability and having sizeable foreign exchange resources. Since the quantum of imports was less both because of low maintenance imports and the absence of food imports, the balance of payments position was relatively stable. But during the middle of the Second Plan, the situation was radically altered. Because of widespread drought, food had to be imported in sizeable quantities and the rising needs of rapid industrialisation necessitated a larger amount of imports than before. In fact, the foreign exchange crisis that developed from the Second Plan onwards was not just a problem of total resources shortage*. Payments deficit arose mainly because of a shortage of investible resources in the country and when increased investment was financed by creating additional money, the inflationary impact manifested itself through heavy deficit in the country's balance of payments.

Thus the impact of inflation upon the country's external payments position has been quite adverse and this is generally found in a period of persistent inflation. Statistical evidence, however, in support of this observation is not available to the required extent primarily because of the

* Vide discussion on this subject, Chapter IV, P.110
complex nature of correlation between prices of domestic output of merchandise items and secondly, for inadequacy of dependable estimates relating to important indices like cost of production, prices of competitive products in foreign markets etc. For these reasons, the observations are more in the nature of a deduction made from the country's past experience over the years. The persistent and substantial rise in prices during the three Plan periods has steadily inflated the cost structure in the economy and tended to lower the volume of exports for two obvious reasons. First, exporters found it more profitable to sell in the home market, and secondly, importers on their part fixed the price of the products well above the international prices. This is undoubtedly one of the main reasons for the decrease in the real volume of India's exports, ultimately leading to the devaluation of the Indian Rupee in June, 1966. The selective incentive measures, viz. credit certificates, import entitlement schemes and straight subsidies in some cases (especially, since devaluation) meant to subsidise higher costs became gradually ineffective.

The relative cheapness of imports gave rise on the one hand to severe import restrictions and on the other to the leakage of foreign exchange through smuggling and other illicit trade channels. Unlike in the Second Plan period, declining foreign exchange reserves could not be used anymore as a cushion during the Third Plan. The availability of aid also could have only


** See p. 119, Section V, Chapter IV. The share of imports in the net national output averaged 7.5 per cent in the First Plan, 6.5 per cent in the Second Plan and 7 per cent in the first four years of the Third Plan. The average annual imports, however, recorded an increase. The marginal decline in imports is due to the policy of import restrictions pursued by the Government.
a limited impact on the flow of consumer goods, as bulk of the aid (excluding P.L. 480) was used for the import of investment goods*. The growing trade deficit and mounting debt obligations characterised the situation. As a consequence, the deflationary impact of imports was not substantial although the absolute level of imports in the last two plans was high enough. Thus all these trends confirm the belief that the balance of payments situation which was more or less favourable at the end of the First Plan tended to become worse during the Second and Third Plans and that a growing price rise at home accentuated the problem by making exports dearer and the rate of economic growth slower.

Our second hypothesis is that a shift in the pattern of income distribution by itself is not a sufficient condition for generating an adequate quantum of saving required for accelerating the rate of economic growth. The study of the Indian economy during the three Plans will largely bear out the logic of this contention.** The data relating to changes in the distribution of income are scanty and hence it becomes difficult to be highly precise on any definitive conclusion in this regard. However, a study on the trends in the distribution of national income during the first three Plans indicates that,

(i) there has probably been some increase in disparity after 1951-1954 and also towards the end of the period in the distribution of personal income by size reckoned at current prices, though the evidence is not conclusive enough;

(ii) there has been a marked increase in disparity in the distribution of personal income by size reckoned in real terms; and

* See p. 149, Section V, Chapter IV.
** See p. 153, Section VI, Chapter IV.
(iii) there has been a progressive increase in the share of income from assets in national income, and a decline in the share of wages, salaries and the income of self-employed persons.*

Alongside, it is found that during the first three Five-Year Plans, there have been considerable declines in the personal savings of the upper income groups in India: they have decreased by more than 50% for those who earn above Rs. 1 lakh and by nearly 43% for those who earn Rs. 20,000 to Rs. 1 lakh per annum between 1960-61 and 1966-67. In corporate sector also the proportion of internal resources to the total sources of funds for Public Limited Companies has declined from 91.4% in 1952-53 to 51.4% in 1963-64. All these cannot but lead to a fall in the volume of private capital formation but as the Government has to continually increase

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* The estimates for fifteen years, 1948-1949 to 1962-63 show that there has been a progressive increase in the share of increase from assets in national income from about 22 per cent to about 26 per cent leading to a decline in the share of participation income comprising wages and salaries and income of the self-employed from 75 per cent to 72 per cent. But the increase in the share of income from assets suggests that there could be some increase in the disparity of size distribution of income at current prices. See "Trends in Distribution of National Income, 1950-51 to 1965-66", a study made by M. Mukherjee and G. S. Chatterjee, Economic and Political Weekly, July 15, 1967, pp. 1259-1268.

The upward shift in the share of income from assets is gradual throughout the period. See Table 2, Ibid.

The share of income earned by both individual assesses and all assesses earning above Rs. 10,000 and Rs. 25,000 per years increased during the period covered. This is suggestive of the increase in the disparity of personal income at current prices. See Table 4, Ibid.

† NCAER, Capital Market in a Planned Economy.
its non-developmental expenditure in the face of inflationary prices, the net effect of high prices has been the decline in real capital formation, which again is reflected in a stagnated economic growth in the last few years of the Third Plan.**

The proportion of aggregate saving during the three Plans averaged 6.5 per cent a year during the First Plan and 8.4 per cent during the Second Plan. During the Third Plan, it reached only a level of 9 per cent which testifies to the proposition that the level of real savings can hardly be raised in a period of unwieldy inflationary price rise. Available data indicate that during the Third Plan, the growth of real saving slowed down to a considerable extent when prices increased at an annual rate of about 6 per cent. In the last two years of the Third Plan, when prices increased at an annual rate of 10.5 per cent, aggregate savings at constant prices showed a decline, suggesting that the price rise during these two years tended to have exercised a regressive impact on saving. Real saving of the household sector also seems to have declined in the last two years of the Third Plan, a trend which suggests that in a period of rising prices households prefer to maintain the existing consumption levels at the cost of generating fresh savings for the purposes of investment.† Thus a communal

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#The inflationary spending gap gradually went on rising which could be met only by allowing further rises in the price level, P. 136, Section V, Chapter IV.

#Government savings also declined considerably during the period. See also Chapter IV, Table 37, p. 136.

4. Ibid NCAER Monograph, "Saving in India during the Plan Period", 1946.

† In the last two years of the Third Plan, while prices went on rising at the rate of 10.5 per cent a year, aggregate savings at constant prices started a decline. See P. 136, Section V, Chapter IV.
shift away from holding of financial assets is almost certain to be associated with a decline in total savings. The result has been that a gradual decline in the value of financial assets other than (or in conjunction with) that of money has offset the possibility of creation of saving forced by any deliberate monetary measure.

Net household saving constitutes an important source of financing investment programmes in the Indian economy since the dimension of the corporate sector is relatively small as compared to the need for it. Besides, financial institutions and capital markets in an underdeveloped economy are either absent or insignificant when compared to the need for channeling the vast flow of capital to the required extent. Hence household savings occupy a central position. But due to a meagre increase in per capita income, the household saving and investment level failed to move up to any appreciable extent. Investment at the end of the Second Plan reached the target of 11 per cent of the national income only because of the massive inflow of foreign aid which amounted to as much as 3 per cent of the national income. Inflation also diverted saving to conspicuous consumption which is evident from the fact that while investment kept on increasing throughout the Second and Third Plan thus yielding a rising stream of income in the community, the level of domestic saving did not register much increase.

It may thus be argued that the sharp inequality as revealed in these findings should have been sufficient to generate a high saving-income ratio. But in spite of all these there has been very little improvement in real saving of the economy during the period of the three Five Year Plans.

If the growth of saving by the private corporate sector and the households was handicapped by the inflationary rise in prices,

@ The upper income groups usually evince a disproportionate trend in consumption, cf. Latin American countries P.98. Ch.II.
S.G.S.Dorrance. "The Effect of Inflation on Economic Development"
it was expected that the shortfall might be made up by Government saving. But in practice this could not be achieved. Usually in an underdeveloped economy, a major role is assigned to a deficit induced investment because it is normally expected that a greater part of the deficit could be utilised for capital formation. But it is interesting to note that the Government's "marginal propensity to consume" in fact turned to be higher than that of the private sector.**

Available data in this regard indicate that additional taxation did not add up to Government savings. The Reserve Bank's estimates also bring home the fact that there was no clear upward trend in absolute savings by the Government during the Plan periods under consideration. The ratio of Government savings to total savings declined from 14.1 per cent in the earlier part of the First Plan to 13.3 per cent in the first half of the Third Plan (in effect, a decade) in unit terms and while in absolute terms the collection of Government savings was impressive, the norm and percentage of saving of both the corporate sector and the household sector was no less in

**In fact, the annual net national expenditure rose from 7.6 per cent and 8.5 per cent during the first two plans to 11 per cent in the Third Plan while increases in real national output were 4.7 per cent, 2.7 per cent and 3 per cent in the three plans. See P. 110, Section V, Chapter IV.

Our third hypothesis relates to the behaviour of the intersectoral terms of trade during the process of an inflation which did not prove to be helpful to promote saving. If the price trends during the Plan periods are reviewed, it would be found that the growth of agricultural production had a decisive bearing on the movement of the price level. On the basis of a ten-year working period from 1955-56 to 1965-66, the per capita income increased only by 8.7 per cent or 0.87 per cent per annum whereas the wholesale price index went up by 78.5 per cent or 7.85 per cent per annum. That a sectoral disparity in the structure of production climaxed this price rise is evident from relative rates of growth of agriculture and industry. The index of agricultural production increased by 39.1 per cent during the 15 years or on an average by 2.6 per cent per annum whereas the index of industrial production rose by 155.8 per cent or 10.4 per cent per annum.

The other effect of rising prices when the pace of agricultural development is relatively low has been a decisive shift in the inter-sectoral terms of trade in favour of the agricultural sector. Since 1960-61, i.e. from the commencement of the Third Five Year Plan, the ratio of food and agricultural raw material prices to that of manufactures has become significantly favourable to the former. From a low of 89.6 at the end of the First Plan, it rose to 126.1 at the end of the Second Plan and with minor dips in the first two years of the Third Plan, it went on steadily rising till it reached 122.5 at the end

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8. The trend became more acute particularly during the Second half of the Third Plan when prices of foodstuff rose by more than 40 per cent, for cereals 76 per cent. See P.141, Section V, Ch. IV.
8. The persistent price rise, particularly during the Second and third Plan was itself the result of a basic imbalance between aggregate demand and aggregate supply, See p.143, Section VI, Ch. IV.
of the Third Plan. This implies that money has flowed from the industrial to the agricultural and trading sectors. But as the demands for industrial goods are relatively low in the agrarian sector, such a movement is bound to adversely affect the expansion of industries particularly in view of the agrarian sector's present assets-investment preferences. Hence, high prices due to a shortfall in the agricultural production may hamper industrial growth.

This had a particularly adverse effect on saving formation. The extent of consumption in the agricultural sector recorded a steep increase and had its unfavourable impact upon the non-agricultural sector. Saving in the industrial sector declined relatively because the latter had to spend more on foodstuffs and other items. This became a prime factor in accentuating inflationary trends in the economy through a demand for higher wages and a subsequent rise in the cost of production. It may, however, be argued that agricultural production gained some incentive in this process but the gain was for the most part offset since production did not increase as was expected. The reasons were, firstly, with a gradual rise in the prices of manufactures (a follow-up action), the cultivators tried to maintain the advantage of the existing terms of trade, but the "cost of living of non-agricultural classes cannot be allowed to rise much, if for nothing else than for political reasons alone." Secondly, a certain degree of elasticity in the small farmer's standard of living in terms of additional consumption beyond a point makes him opt for a little less hard-work when for sometime during the year he has to labour extremely good indeed to make both ends meet. Thus the implied Government policy to subsidise agriculture through a change in the sectoral terms of trade by emphasizing rapid industrialisation programmes, ultimately failed to promote saving and neutralise the rise in prices. Thus our third hypothesis is also confirmed.


* Conditions of agricultural supply also largely determine the nature of industrial development. For reference, see P.W. Section VI, Chapter IV.
Our fourth hypothesis is that inflation affects economic growth through a shift in the pattern of investment resources and activities because the return on real capital investment is adversely affected. Inflation appears to have affected investment and savings particularly during the Third Plan. The available estimates on aggregate investments during the three Plans show that the real content of investment has been reduced gradually as investments in financial terms could be realised only at higher prices. Aggregate investment at 1948-49 prices showed a much smaller increase in the Third Plan than in the first two, indicating the regressive impact of the price rise on investment. Although inflation may have initially induced investment, it seems to have delayed the fulfilment of investment plans for want of availability of physical resources. This is reflected in the shortfalls from output targets in certain sectors of the economy.

At the same time, there was also a scarcity in the availability of real capital which was further accentuated as time went on. Capital being an essential input, any rise in its supply price will have an obvious effect on the total cost of production and consequently on the selling price. As a result, the cost of capital also moved too fast in the upward direction. This happened because of the inflationary price rise which also induced a diversion of resources to those forms of investment on which there is scope for large capital gains, viz., gold, land, urban house property and commodities experiencing price rises.12


* The average annual increase in investment at current prices decreased from 14.5 per cent in the First Plan to 10.7 per cent in the Second Plan and 4.2 per cent in the Third Plan. See Table 34, P.134, Section VI, Ch. IV.

** See Table 30, 31 and 33, Section VI, Ch. IV.
The shares and equities markets also reflected a similar trend. Although the prices at which industrial securities are transacted remain largely undisclosed, both preference capital and debenture capital could be floated only at a higher price. The same is also true of the working capital of the business for this could not be secured at less than 8 to 10% rate of interest at the end of the Third Plan. Inflation also gave rise to the creation of a massive amount of black money or unrecorded gains, which could not be utilized in productive investment. Although an exact estimate cannot be given here and now, the fact cannot be disputed that black money employed for conspicuous consumption, inevitably adds to the spiral of rising prices. Where it is used for buying real estate and other assets, it blocks up productive enterprises. Inventory holdings do also increase during a period of inflation and, to that extent, it withholds supplies of essential goods from the market. It is difficult to form an estimate of the size of unproductive investment in the Indian economy, but from all available indications, it must be considerable.

Finally, the last hypothesis relates to the wage-price relationship and the modifications it undergoes during a period of inflation. When wages rise faster than increases in productivity, there is the cost-push type of inflation. However, data relating to increases in productivity are not readily available. Some of the findings of the National Commission on Labour may be worth noting in this context. For the last two decades, neither money

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8Much the same thing happened in the Latin American Countries when the extent of price rise was considerably steeper. See pp. 12, Chapter II.
wages have been associated with a rise in real wages nor a rise in the latter item have been found commensurate with the improvements in productivity. These observations are based on considerations of productivity, labour costs and the wages bill respectively. The analysis of productivity changes relates to a study covering the period 1952-64 and, "using the index number of wholesale prices, it reveals that production per worker has increased by about 63% and a part of it has been contributed by labour whose real earnings have remained almost static during the period". It has also been pointed out in the Annual Survey of Industries that "the percentage of wages to the value added by manufacture shows a decline from about 50% in 1949-50 to about 40% in 1958. In subsequent years, wages as a percentage of value added declined by about 40% in 1960 to 36.5% in 1964. As we all know, the real earnings of wage earners in India with an income of less than Rs.200 per month have declined by approximately 22 percentage points between 1955 and 1964 and those of earning less than Rs.400 per month by about 8 percentage points between 1962 and 1965. Even if it is conceded that wages rise during a persistent inflation, the increase in wages leads to price rise not directly but through subsequent increase in aggregate demand."

Since the ratio of wage cost to total cost is small, a rise in wages alone would not produce a significant impact on the cost of production occasioning a price rise. The insignificant ratio of wage earning to national income excludes any possibility of raising prices through a rise in wages and a consequent

* NCAER, Capital Market in a Planned Economy.
change in demand. Further, the initial price-rise does not lead to an immediate rise in wages. In an economy where the degree of unionisation is low in many industries - viz., 61% in cotton textiles, 37% in coal mines, 29.4% in paper and paper industries - it is quite unexpected that trade unions' pressure will be strong enough to effect increases in wages in a short period.

In the light of these facts it is clear that money wage increases in India cannot unleash either a demand-pull or a cost-push type of inflation. This does not mean, however, that wage price movements do not have any impact on domestic saving and capital formation. The erosion in real earnings of the wage and salary earners through inflation stands to cause a decline in real personal savings and real capital formation in the economy. There have been considerable declines in the personal savings of the upper income groups in India; they have decreased by more than 50 per cent for those who earn above Rs. 1 lakh and by 42/45 per cent for those who earn Rs. 20,000 to Rs. 1 lakh per annum between 1960-61 and 1966-67. In the corporate sector also, the proportion of internal resources to the total sources of funds for Public Limited Companies has declined from 91.4 per cent in 1952-53 to 51.4 per cent in 1963-64. All these cannot but lead to a fall in the volume of capital formation.

These facts may be adduced in favour of the hypothesis though, admittedly, a much more detailed study than has been undertaken here is required for arriving at a more definite conclusion in this regard.

* V.B. Singh, An Introduction to the Study of Indian Labour, page 8.
** NCAER, Capital Market in Planned Economy.
The main object of our study has been to examine how the economy functioned under the impact of an inflationary rise in prices, a trend which was accentuated from the Second Plan onwards. To facilitate the study and to make it more precise, a set of hypotheses were framed regarding the behaviour of some basic variables during the period. These hypotheses were drawn up on the basis of existing literature on the subject and the case studies of Japan and some Latin American countries made in Chapter two. These hypotheses were later on tested in the light of experience gained from the working of the Indian economy and almost all of them appear to have been borne out.

It is, however, difficult to be highly precise on the rather vital issue of correlation of inflation and economic development since results would vary in individual cases as socio-economic factors and the institutional set-up
cannot be excluded. On the basis of our study, it cannot but be observed that persistent inflation is not likely to become an inducement to economic growth. A continuous rise in prices, by steadily eroding the value of money and by inflating the domestic cost structure, adversely affects the formation of real saving and real investment and in its turn, significantly reduces the rate of growth of the net national product of the economy. This observation amply held good for the Indian economy as has been illustrated in the present work. This also upholds the conclusion that inflation by short-circuiting the path of economic growth actually proves to be a bogey to all development activities.

In the light of experience gained from a study of the Latin American countries, the observation is equally confirmed that inflation acts as a deterrent to productive investment and in its turn, economic growth. A contrast has, however, been noted in the case of Japan where a deliberate follow-up of an easy money policy helped the process of development. But it is in this context necessary to note that there existed a number of qualifying factors that acted as a cushion to the inflationary pressure which, however, unfortunately did not exist in India. For instance, a rapidly growing population and the agricultural reserve in Japan acted as a restraining factor against any probable trend of a rise in wages and the social climate in Japan also did not favour the rapid growth of trade unions. Again, on the demand side, the social and fiscal policy tended to be highly regressive in character so that a large proportion of income gains could be easily channelled into the hands of the wealthy classes that encouraged capital formation to a great extent. The latter factor by itself acted as a safeguard against the likely excesses that could arise as a sequel to the cheap money policy, so that inflation could not adversely affect the trend of real growth of capital in that country. Finally, her import and export policies were so timely and well-designed that
these could successfully restrict the duration of short-term booms and at the same time boost the country's exports to the international markets at a time when other countries were at a relatively less advantageous position. With all these qualifying criteria existing in her economy, Japan could effectively ensure a rapid development despite a liberal policy of monetary expansion deliberately chosen and pursued throughout the period.

The Indian experience, on the other hand, does not provide any ground for believing that a deliberate policy of monetary expansion could become in any way helpful for the purpose of mobilising the real resources of the economy. Our conclusion is that, inflation, at least in this case, has proved to be the negation of planning in advance, indeed its very anti-thesis. A stable price level, on the other hand, would have ensured drawing up a rational plan, avoided sudden shifts of economic schedules and, prevented unwarranted fluctuations in the prices of investment projects. The Indian experience in our period of study definitely shows that inflation is certainly not helpful for rapid economic growth.