

Inflationary Growth: A 'Win-Win' or a 'Lose-Lose' Proposition?

During the three decades beginning from 1978, Sri Lanka had recorded, on average, an annual inflation rate of slightly over 11 percent. During the same period, its annual average economic growth rate amounted to 5 percent. These two macroeconomic numbers have prompted many to argue that inflation does not matter since, despite the two digit inflation, a comfortable economic growth rate has been maintained by the country. This argument, at an extreme level, is extended to even scoff at price stability as a goal of the society. If the economy could grow at 5 percent and the real per capita income can grow closer to 4 percent per annum, why worry about inflation? Why not inflate the economy, the easiest way to generate financial resources for investment in a resource scarce economy, and raise wealth and well being of the people? Some have extended this argument even further that for a developing country, price stability should not be an appropriate policy goal and governments should mobilise resources through inflation. This easy-to-fix-the-economy-strategy has won favour with politicians, bureaucrats and top-level policy makers. The result has been a tendency to use bank credit liberally and maintain economic activities at a higher level to keep the much dreaded economic recessions at bay.

The experience in other Asian countries, notably Singapore and Malaysia, has been somewhat different from what Sri Lanka had in this period. They had low inflation coupled with much higher real economic growth.¹ While Sri Lankans have been happy about high inflation and moderate economic growth, policy makers in those countries have been sceptic of the ability of inflation to generate permanently high economic growth and create wealth on a sustainable basis. Goh Keng Swee, the economic architect behind Singapore's economic miracle recalled in 1992 that his Cabinet colleagues in the early 1960s did not believe that printing money could bring prosperity to Singapore. According to him, "**diligence, education and skills will create wealth, not Central Bank credit**"² Accordingly, Singapore decided to continue with the self-disciplined currency board system, prohibited the Monetary Authority to lend to the government and maintained the strictest fiscal discipline by balancing the budget. Thus, Singapore was able to create an environment conducive to economic growth, namely, the establishment of a low inflation regime, in addition to other real sector

adjustment policies.³ The result attained was dramatic and without parallels: within a matter of about three decades, Singapore could elevate itself to the status of a developed country.

Inflationary Growth

As mentioned above, the argument that developing countries should have a moderate inflation to spur economic growth is very popular among many. This view is held even by some economists and academics. It lays down its rationale as follows: in developing countries, the private sector is weak; hence, the desired resource allocation through the market system does not take place; the failure of the market makes it necessary for the state sector to step in; however, due to weaknesses in tax systems and the inflexibility in capital markets, the governments cannot raise the needed resources to finance the required expenditure programmes; as a result, the governments may mobilise the private resources for investment through inflation. This is akin to imposing an inflation tax on the economy and generating growth through inflation. The proponents of inflationary growth further argue that the initial inflation created by the government's inflationary financing is self-destroying. That is because the consequential expansion in aggregate supply later would eliminate the demand gap in the economy and cause the inflation pressures to gradually die out. It is this self-destructive property of inflationary growth which has in fact made it attractive. Jayawardena counters this proposition quoting a quip attributable to J.K. Galbraith that "**a little bit of inflation, like with a little bit of pregnancy, has the awkward habit of growing**"⁴ The risk of creating moderate inflation to generate growth is that the moderate inflation can become a high inflation and the high inflation can regenerate to a hyperinflation.⁵ If this happens, the initial gain in output growth is not only completely negated, but also the pillars of long-term growth in the economy are totally destroyed denying the economy of its future growth opportunities.

The Production of Real Goods and Services and Real Welfare of People

An economy produces goods and services and the total quantity of such goods and services, known as the national product, determines the welfare level of people. Those goods and services

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which constitute real quantities rather than designated or nominal values, will enable people to have a higher level of consumption and a higher level of real welfare.⁶ The rate of growth in those real goods and services is known as economic growth. If this rate of growth is continuously high year after year, then the real quantity of goods and services available for use by people too expands continuously. As a result, the real welfare level of people too will become higher. The increase in the nominal value of these goods and services, by the same argument, does not lead to an increase in the welfare of people. It simply increases its money value and does not contribute to increase the availability of real goods and services. Hence, what a society should strive to achieve is to raise the real quantity of goods and services and not its nominal value expressed in terms of money.

What contributes to increases in real goods and services? Since they are produced by using real inputs like labour, raw materials, equipment, machinery etc., the total quantity of real inputs utilised by a society basically determines the total quantity of real output too. This is known as the level of real resource utilisation. Then the type of technology used for converting real inputs into real outputs too helps a society to produce a larger quantity of real outputs out of a given level of real resources. The level of real resource utilisation and the technology used for conversion are determined by hard work, diligence and innovativeness of people. If this can be achieved by using money, in other words, by inflating the economy, then, inflation is a determining factor of real economic growth.

Can Inflation Generate Permanent and Sustainable Growth?

Then the question that arises is whether it is a temporary growth or a permanent and sustainable growth. If it is only a temporary growth, the continuous inflation would certainly bring about a disastrous impact on the economy in the long run. But if it is a permanent and sustainable growth, then, inflation could justifiably be used as a promoter of economic growth.

When the government uses money printed by central bank or created by commercial banks to finance its

Economic Review: January 2009

* The views expressed in this paper are those of the writer and do not in any way represent those of the Central Bank of Sri Lanka or its Monetary Board.

expenditure, whether recurrent or capital, it gives an additional money income to ultimate recipients of government expenditure. This new money income makes people believe that they are richer than before. This feeling known as **'wealth effect'** will incentivise them to work harder, contribute more to the national output and work more innovatively and diligently. Hence, the output will immediately rise and a higher economic growth will be recorded. But for this economic growth to be a permanent and sustainable growth, people should feel that their relative position in the society too has improved with the new money income. For instance, when they compare themselves with their neighbours, they should feel that they are now better off than their neighbours. But government expenditure programmes raise the money incomes of everyone and, therefore, everyone would feel same as before.⁷ Soon the feeling of richness which the new money income had initially created in their minds would begin to die out. At that level, the initial hard work they had performed would also die out bringing the growth rate to the previous level. To incentivise them anew, the government has to continuously inflate the economy by using central bank money or commercial bank credit. But the government would then be caught in an inescapable vicious circle of inflation.

Hence, inflation would bring only a temporary outcome and cannot sustain economic growth in the long run. Even the benefits of the initial temporary increase in the real output are negated in the long run due to the disastrous effects which continued inflation would entail on the economy. It may initially seem as a **'win-win'** situation for both the government and the people. Once the inflation starts to raise its ugly head reducing all real values, it would be a **'win'** situation for the government because it can still mobilise real resources from the economy and a **'lose'** situation for people because it erodes their real welfare. Once inflation becomes a long term feature, it would be a **'lose-lose'** situation for both the government and the people.

Why Inflationary Growth is a 'Lose-Lose' Outcome for All?

How could inflation become a lose situation for the people in the long run?

If people are unable to increase their income along with inflation, they would immediately experience a decline in the real value of their income. For instance, if the inflation in a given year is 10 percent and if the money income of people does not increase by that percentage, they could now buy a smaller basket of goods and services with their income after the inflation has set in. It would then mean a

reduction of the real welfare they had enjoyed earlier. However, this would not apply to those who have been able to raise their money incomes along with inflation. This category of inflation beaters are small in number and consist of professionals such as lawyers, medical experts and workers whose incomes are automatically adjusted to inflation. Since majority would experience a reduction in the real welfare level, inflation would have brought an undesirable redistribution of income in favour of a few individuals. Jayawardena amplifies this undesirable development as follows: **'Importantly, price inflation, whether moderate or not, always imposes an iniquitous inflation tax on the weakest members of a community and confers windfall gains, large or small, on its affluent members'**⁸

This situation becomes worse if interest rates are not adjusted upward adequately to compensate for inflation. In that case, real interest rates become negative because money interest rates fail to adjust according to the inflation rate. This in fact creates a peculiar situation in the sense that savers or lenders are not adequately compensated, while borrowers are more than adequately remunerated. Hence, it is tantamount to savers or lenders paying interest to borrowers. The end result is the drying up of both saving and lending and the proliferation of borrowing. When savings flows dry up, governments being the largest borrowers would emerge as the biggest casualties.

Persistent inflation is also anti-growth and people would lose on that count too. If interest rates are not adjusted adequately, the real value of financial assets would get eroded by inflation. People in a bid to insulate themselves from inflation would convert investments in financial assets into unproductive real assets such as property, buildings and bullion. These investments do not bring new incomes and outputs, but simply kept as idle assets to benefit from increases in their prices. Further, inflation distorts the resource allocation function of the market system leading to a failure of the market economy. It creates confusion among market participants thereby creating a chaotic situation. Everyone would only be concerned about the short run, and therefore much needed long-term investments would dry up. This retards the long-term economic growth.

An undesirable development of persistent inflation is the tax it imposes on exports and the subsidy it pays on imports. When domestic inflation is high, selling export commodities in the domestic market becomes more profitable. Similarly, inflation favours imports because imported goods become cheaper than domestic goods. This would discourage exports

and encourage imports creating a trade gap which in turn would exert pressure on the foreign reserves and the exchange rate. In the long run, the country's competitiveness is eroded bringing serious implications on the foreign trade sector.

Inflation is also an anti-poor phenomenon. This is because the poor with their lower bargaining capacity are unable to get themselves adequately compensated for inflation. The most vulnerable groups in this sense are pensioners, housewives, students and government servants whose salaries are not indexed to inflation. However, the well-to-do are able to have their asset structure readjusted to avoid losses and increase profits in addition to raising their incomes along with inflation. Hence, inflation redistributes income from the poor to the rich.

Inflation is the worst enemy of people because it exerts fear, helplessness, destitution and hopelessness in them. Irrespective of age, sex, wealth, creed or race, it impoverishes everyone, if people have not indexed their income to inflation. It creates uncertainty and uncertainty creates confusion in everyone. It reduces people's action to very short run goals making them creatures without hope or a future. The writer has, therefore, equalled inflation to an enemy worse than a terrorist.⁹ Hence, inflation brings a **'lose'** situation to people.¹⁰

A 'Lose' Situation for Governments

How should inflation become a **'lose'** situation for governments bent on inflationary growth?

Governments lose due to inflation, because they get trapped in a vicious circle of inflation. Inflation raises government expenditure, but retards its revenue. The resultant deficit in the budget need be financed through borrowings, but the drying up of the savings flows in the economy due to interest rate restrictions make it difficult for governments to finance budget deficits by borrowing from the market. Then the governments will be forced to resort to borrowing from the banking sources, especially from their central banks. It breeds further inflation making it necessary for governments to continue to tap the resources in the banking sector. When budget deficits are funded out of money printed by the central banks, it amounts to imposing an inflation tax on the economy. When the initial moderate inflation regenerates to a hyperinflation, governments lose their ability to impose inflation tax any more because people would refuse to accept the currencies issued by the central banks. At that point inflation tax becomes impotent and governments are driven to virtual bankruptcy.¹¹

With persistent inflation even at a moderate level, governments lose on two other counts.

Inflation raises interest rates and high interest rates in turn raise government's interest expenditure. This would prompt many governments to resort to unofficial interest rate controls. Such controls make the position of governments worse because they dry up normal savings flows, create higher savings-investment gaps, cause capital flight, retard economic growth and impede tax collections, making it more difficult to finance government expenditure programmes. Sooner or later, governments come to a position in which they have to pay a very high price in the form of having to make the full adjustment of interest rates. However, by that time, markets have completely been disabled and the corrective measures taken by the governments would fail to work. Hence, imprudent interest rate controls in the wake of persistent inflation provide only temporary relief to governments and should, therefore, be avoided.

Higher inflation in the domestic economy than in the competitor countries imposes pressures on the exchange rate, since inflation discourages exports, encourages imports and causes capital flight. This would drive many governments to a dilemma because a depreciated currency is normally viewed as a loss of national prestige and dignity and also a failure of government's economic management. It also raises the value of government's external debt in terms of local currency. Like in the case if interest rates, governments would therefore prompt to maintain overvalued exchange rates which erode the competitiveness of exports and thereby exert further pressure on the exchange rates. By resorting to this imprudent tactic, many governments have come to grief eventually, because they have not been able to hold onto the overvalued exchange rate as well as the foreign reserves. Jayawardena makes the following comment in this connection.

"If domestically induced inflation prevails, a policy to restrain the necessary exchange rate depreciation for political reasons will prove to be not only futile, but also more costly in terms of both the level of the exchange rate adjustment eventually necessary and importantly the scale of required structural adjustment of the national economy itself. The moral, amply confirmed by historical experience, is that sooner the exchange rate is adjusted to conform to the changed conditions confronting the economy, the sooner will it be able to achieve recovery and stability"¹²

The moral of all this is that governments lose ability to hold onto both interest rates and exchange rates

in the wake of persistent inflation. The worldwide experiences show that when there is persistently high inflation in countries, the domestic interest rates tend to be higher and exchange rates tend to be continuously depreciating. Hence, if the desire is to maintain low interest rates and stable exchange rates, inflating the economies for budgetary purposes should be avoided at all costs. Hence, inflation leaves governments too, like people, in a **'lose'** situation.

What should be Done?

Inflationary growth makes it necessary for governments to intervene in the markets to rid the economies of the ill-effects of persistent inflation. However, such interventions make the matters worse. John Exter, founder Governor of the Central Bank of Ceylon, compared the Federal Reserve Bank's printing of dollars to a far worse economic disaster than what was experienced in the 1930s. He announced that **'Since money runs like water, market forces every minute of everyday try to restore equilibrium, while central banks worldwide, especially our own Fed, intervene every minute of everyday to prevent it'**.¹³ He then said that such interventions create uncertainty and markets do not like uncertainty. His prognosis was that markets would win eventually and not the governments.

Governments should avoid using inflation for creating output and employment. This is because inflation being a nominal weapon cannot bring about real outcomes. This wisdom had been displayed by the old guards in Singapore who refused to believe that money can create wealth. As Goh Keng Swee put it later, **'the way to a better life was through hard work, first in schools, then in universities or polytechnics and then in the work place'**¹⁴

Hence, wealth creation in a society should be left to people who work hard and not to inflation.

In summary, inflation is an inadvisable weapon to use for propelling economic growth. There could be a temporary uplift of the economy consequent on the initial onset of inflation, but that improvement is not a sustainable one. Inflation brings catastrophic consequences to a country. While people become impoverished, governments lose hold over both interest rates and exchange rates. Hence, inflation leaves both the people and governments in a **'lose-lose'** situation.

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Footnotes

¹ For details, see Thenuwara, H.N. (2008)

² Goh Keng Swee, (1992), p 33.

³ Yergin, Daniel and Stanislaw, Joseph, (1998) p 166.

⁴ Jayawardena, N.U. (2008), p 66

⁵ For the outcome of inflation tax, see, Wijewardena (1995) and Wijewardena (2007).

⁶ A real quantity is something which people can consume and enjoy. Two examples are rice and movies. A nominal quantity cannot be consumed directly and has to be converted into a real quantity. For example, money being a nominal quantity has to be converted into rice or a movie for anyone to enjoy it. Hence, rice is a real quantity, but when its value is expressed in terms of money, it becomes a designated or a nominal quantity. While increases in the quantity of rice improve welfare, increases in its price do not do so.

⁷ A similar psychological feeling would be held by people in a work place, if everyone has been promoted simultaneously. It would leave workers in the same comparative position after the promotion and the initial euphoria of promotion would soon die out. As a result, it would not incentivise them to work harder in the long run. To get them to work harder continuously, they should be promoted again and again and it is then akin to creating a 'promotion inflation' in the work place.

⁸ Jayawardena, (2008), p 67.

⁹ Wijewardena, (2008), p 14

¹⁰ One could imagine the plight of people in Zimbabwe where inflation ran at 531 billion percent per annum by end September, 2008. www.centralbanknews.com

¹¹ A good example is Russia in 1992 when hyperinflation caused the collapse of the Rouble. The Russian Government could not fund itself by issuing any more Roubles. Nor was it able to raise tax revenue because of the collapse of the economy. Hence, salaries had to be paid in vodka.

¹² Jayawardena, (2008), p 66.

¹³ Quoted by Greg Pickup. www.fame.org

¹⁴ Goh Keng Swee, (1992) p 33