Economic Growth And Inflation : A Perspective

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ABSTRACT

In this paper, the author has tried to examine the relationship between inflation and growth, and if they are indeed the two sides of the same coin. The author has given a theoretical approach to begin with, by illustrating the theories of Adam Smith, Karl Marx & A.W. Phillips and their approaches towards inflation and how they fare in the current scenario. To substantiate his argument, the author has used the data from World Bank Reports and highlighted the inverse and direct relationship of inflation and growth in the short run. The author has mentioned the case of Asian Powerhouses like Singapore and South Korea & how they managed to have an impressive growth rate with a manageable inflation rate and how this negates the assumptions of A.W. Phillips. The author has also tried to throw some light on the reality of the growth story of India characterized by growing unemployment levels using data from NSSO to validate his point. A critical examination of the relationship of Inflation and business cycles has been done, and it was found that they have been a function of several other factors and not inflation necessarily. The author also analyzed the impact of government policies on inflation & since the nature of inflation has been of a 'cost push' one, it is difficult for any government to control it through monetary policy. The author finally concluded by attributing growth to be a function of numerous factors and ,therefore, we have to exercise caution while attributing inflation as a determinant of growth and all the while, we have favoured government intervention for growth of an economy.

Keywords: Inflation, Growth, Business Cycle, GDP, Economic Policy

INTRODUCTION

The relationship between inflation and economic growth has been one of the most debatable topics in economics as well as in the sphere of political economy too. It isn't uncommon to find media proclamations like *"the central bank chose to control the inflation over maintaining the growth rate."* So, naturally, corporate, social & political circles are abuzz with talks of an inflation-growth trade-off. But then, the question arises as regards to the existence of the kind of relationship they have & the extent of such an existence.

To answer questions like these, the researcher has tried to develop a theoretical framework and examine the real-world experiences in that light. The pioneer of economic thought-Adam Smith, tried for the first time to capture the economic behaviour of people in theory. He expounded the theory of the *'invisible hand of the market'* where in, he mentioned about the supremacy of the Market Forces & how what to produce (Nature of Produce), how much to produce (Quantum of Produce) & for whom to produce was decided by the market. The basis of his theory was the division of labour, pursuit of self-interest, and perfect competition. As capitalism developed on his theory and continuous expansion of production of goods occupied the central picture in the society, Karl Marx gave his analysis, describing what actually is the reason behind this continuous expansion & introduced the concept of *'Surplus Value'* to the society.

Surplus value is the surplus produced over and above what is required to survive . This surplus value is translated into profit in capitalism. According to Marx, it comes from the underpayment of wages to the labourers. As the business progresses, this surplus value gets reinvested again and again, and it is this reinvestment, which is the source of 'growth' -tangible growth. Here, growth of money gets separated from the production of goods. Thus, we see how economic growth has very little to do with inflation. However, on the other hand, we have theories, which highlight the inverse relationship between rate of unemployment and the rate of inflation in an economy (The Phillips Curve). In other words, the lower the unemployment (the higher the growth), the higher the rate of increase in wages (i.e. increase in inflation) paid to the labour in that economy. This relationship holds in the short run. In the long run, this relationship does not hold because monetary policy can no longer affect unemployment and hence, growth. Whatever

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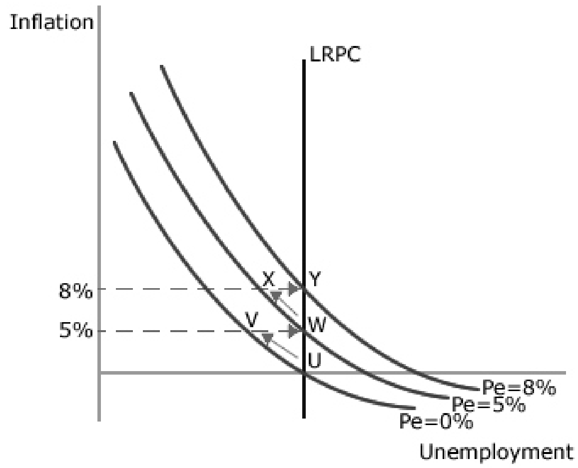
Figure 1 : An Illustration of The Phillips Curve



Source : "Theory 4 - Theories - Causes - Inflation - Monetary Policy - Economics bank – Virtual Bank of Biz/ed" accessed on April 20th 2012
http://www.bized.co.uk/virtual/bank/economics/mpol/inflation/causes/theories4.htm

little experiences we have had so far where we observed a trade-off between these two variables can be explained by this theory and only in the short run, where we have the sticky prices assumption but then, in most of the cases, we do not have sticky wages. Furthermore, there is also a possibility that if the expected inflation is not so high, then high growth is possible with low inflation. The greatest drawback of this relationship is that it does not capture the other factors which go on to determine the growth. It assumes that growth in the money supply is the most important determining factor of growth. But in today's scenario, we cannot negate the impact of human capital, technology, good governance, and cultural factors, etc. as the determinants of growth.

As illustrated in the Figure 1, at higher inflation expectations (Point Y), the inflation is higher with respect to Point W, where inflation expectation is lower with the same unemployment rate . In the long run, unemployment rate is

Table 1 : Inflation and Economic Growth Trends In Selected Countries

Country	1965-80		1980-89	
	Inflation Rate	Growth Rate	Inflation Rate	Growth Rate
Brazil	31.3	9	227.8	3
Columbia	17.5	5.7	24.3	3.5
England	10.7	2	6.1	2.6
Finland	10.6	4.1	7	3.6
Germany	5.2	3.3	2.7	1.9
Hong Kong	8.1	8.6	7.1	7.1
Italy	11.4	3.3	10.3	2.4
Japan	7.6	6.6	1.3	4
Norway	7.7	4.4	5.6	3.6
Singapore	5.1	10	1.5	6.1
South Korea	18.4	9.9	5.0	9.7
Spain	12.3	4.6	9.4	3.1

Source: World Bank- Informe Sobre el Desarrollo Mundial (1991) accessed from the Book 'Economic Policy and Stabilization in Latin America' by Nader Nazmi (p.10) independent of inflation. Points Y, W and U correspond to the short-run Phillips Curve. Chile, Columbia, Costa Rica & Turkey are few countries that have witnessed an inflation of 20% or above, with GDP Growth of more than 3% (World Bank Report,1993). If we plot the above data in the Phillip's Curve, the inflation and unemployment (here growth) co-ordinate will lie on the upper end of the short-run Phillips curve, where we have high inflation and low unemployment (high growth).

To substantiate the above argument, we have a very good example in the form of the growth story of Asian giants, which is often called 'The East Asian Miracle'. The volatile period of 1965-1980 characterized by oil crisis and the Vietnam war in Asia, Singapore managed to achieve an impressive average GDP growth of 10%, while keeping average inflation rates at 5.1 % (Refer to Table 1). Similarly, South Korea during its Peak Growth period of 1980-89 had an average GDP growth rate of 9.7%, with inflation at a manageable level of 5%.

Now, what were the reasons for the success of these East Asian Economies? Good governance and hard work of people can be outlined as major reasons amongst a host of others. So, high-inflation- high-growth strategies are simply temporary boosts to economies, which can't sustain themselves.

Table 2 : Employment and Unemployment Data (By Usual Principal Status)

	1983	1988	1994	1999-00	2004-05
Labour Force	308.64	333.49	391.94	406.05	469.06
Workforce	302.75	324.29	374.45	397.00	457.82
Number Of Unemployed	5.89	9.20	7.49	9.05	11.24
Unemployment Rate (in %)	1.91	2.76	1.96	2.23	2.39
GDP Growth (in %)	7.70	3.80	5.90	6.40	7.5

Source : The Figures are in Millions unless otherwise mentioned

1. Employment, Unemployment, Unemployment rate and Labour force are on Usual Status basis and are based on estimates given in various rounds of NSSO (Published by Ministry of Statistics and Programme Implementation, New Delhi ,Government of India)

Employment & Unemployment Situation in India, NSS 50th Round (July 1993- June 1994). Report No. 406.

Employment & Unemployment Situation in India, NSS 55th Round (July-December-2002). Report No. 455

Employment & Unemployment Situation in India, NSS 61st Round (July 2004 - June 2005). Report No. 515

2. GDP growth rates are from the report "Data for use of Deputy Chairman, Planning Commission" accessed on April 20, 2012
http://planningcommission.nic.in/data/datatable/1705/databook_dch_160511.pdf

The common prevailing belief is that you can't have growth without high inflation, with the basic assumption being that an increase in the money supply (and hence, inflation) drives growth, e.g. deficit financing by the government to carry out development projects, etc. However, this does not necessarily mean that high inflation leads to high growth. There can be others reasons for high inflation. Taking the example of India and analyzing the current economic scenario, we observe that we are passing through a phase of inflationary trend. However, at the same time, our growth rate is not improving significantly. Here, it is a pure case of imported inflation & the reasons being high oil prices, high global food prices owing to the food crisis. So, we can't expect the growth rate to improve significantly. Another very significant observation from the happenings of the post-liberalization phase is that there is a significant improvement in the growth rate, but the unemployment rate has gone up (Illustrated in Table 2), as jobless growth has been the hallmark of this period. So, after observing these cause and effect relationships, if at all it exists, from different planes, it would be difficult to call inflation and economic growth as the two sides of the same coin.

Figure 2 : Inflation Trend in India (By CPI)

It is very common and fashionable among the economists to talk about business cycles, even if they themselves are not convinced if really a business cycle exists or not. However, by averaging out the fluctuations, if we are able to identify a business cycle, it will be very difficult to explain it on the basis of a given theory. In some cases, it can be the fiscal policy which is responsible for a particular trend in the business cycle, whereas in other cases, it can be monetary policy, and in some other cases, it can be demand side constraint or supply side constraint. So, it is very difficult to explain business cycles on the basis of a particular theory. Then, it would be unwise to call that inflation has been pivotal in all the cases of booms and recessions. In the US, since the Second World War (1939-1945), the business cycle was a function of economic policy. Severe recessions of both the early 70s and 80s can be directly attributable to Fed's decision to raise interest rates. Booms of mid 60s and mid 80s were fallout of easy monetary policy and a decrease in interest rates.

As far as government policies and their impact on inflation and thereby, on growth are concerned, it has been a matter of alacrity for the government because the political dimension comes in here. Across the globe, inflation is generally a cost-push one and in such cases, monetary policy as a weapon cannot be used, and non-monetary measures are called for. In India (Refer to Figure 2), the government has been using price controls, subsidies and even the actions of central bank have been influenced to a great extent. Now, what has actually happened is that instead of controlling inflation, it has increased inflation because with such moves of the government and with fluctuation in world prices, the inflation expectations have gone up and consequently, has led to effective inflation. The growth rates have too gone up, but not because of this, but because it is cost push inflation and not demand pull inflation. Noted economist Amit Bhaduri in his popular book *'Development with Dignity'* has argued for government intervention for development and has argued that the government should not fear fiscal deficit (resulting in inflation) as the increase in the purchasing power at the hands of the customers would be enough to counter the inflation. National Rural Employment Guarantee Act (NREGA) of the UPA government is a perfect example of that. No one has, until now, attributed the recent increases in inflation to the resources diverted for NREGA.

Through this paper, the author concludes that the notion of growth-inflation trade-off does not have an empirical and theoretical support. There is also enough empirical evidence that in the long run, there exists a statistically significant negative correlation between the two macroeconomic variables. The result has major policy implications for the policy makers. It reaffirms the fact that the primary objective of the monetary policy must be to ensure price stability or in other words, to control inflation. It also strengthens the case for an independent monetary policy that is governed free of the short-term political compulsions, and with a view to promoting long-term growth and stability. The world experiences tell us very clearly that we need to be cautious in attributing the cause of economic growth to inflation. Economic growth can be driven by inflation, but only in the short run. It is not sustainable in the long run. Growth is a function of numerous factors, which need not necessarily include inflation as illustrated in the case of Singapore and Korea.

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