

Gosalia, Sushila

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# Industrial versus Developing Countries

by Sushila Gosalia, Mannheim

**T**he subject of inflation is no more an intellectual exercise to provide the basis for the class room discussion, but it has become a realistic problem, inviting and testing economists and policy-makers in handling it without jeopardising the steady growth in the economy. Control of demand is most decisive in current economic policies. Compared with the interwar period, when lack of demand caused large-scale unemployment, Western countries have after the war been remarkably successful in maintaining sustained economic growth with few and small interruptions. However, new problems have come up. In a number of Western European countries as well as in the USA there have been inflationary tendencies in recent years mainly due to excess demand.

### **Creeping Inflation in the Western World**

In the years after World War II, inflationary pressures seemed part and parcel of the process of post war reconstruction. There were massive backlogs of investments as well as of consumer needs. At the same time exceptionally large cash reserves were available to finance the purchases of these goods. Without passing judgement on the skill with which the inflationary pressures of those years were handled, one can say that they were regarded as a problem of reconstruction and were not considered to be of permanent importance. Similarly the wave of inflation, which followed after the outbreak of the war in Korea, was not regarded as a permanent threat to monetary stability. It was based on an extraordinary volume of speculative purchases by business firms and consumers. When the buying wave subsided the manifestation of inflation appeared to be over. In 1952 a new period of economic expansion began, in which persistent inflation was not generally anticipated or feared. One was confident that the governments could through their stabilisation policy maintain a high level of employment and adequate economic growth. Governments were determined to prevent a relapse of the conditions of unemployment and stagnation of the 1930s.

In the following years however rising prices proved to be a continuing problem. On the whole, remarkable success was achieved in maintaining high employment. The growth of production was very satisfactory in many countries. But after a brief pause, prices in most countries showed a persistent tendency

to rise. This tendency was accompanied by sharp imbalances in international balance of payments and by distortions in the economic structure, which became a serious obstacle to continuous economic growth. In many quarters of the economic world it is believed that there is no serious threat of inflation in the months immediately ahead and that the danger of runaway inflation can be practically dismissed for the reasonable future. But the economic world is faced with a threat of gradual or creeping inflation over the coming years. This conclusion is based on the tacit assumptions:

- ☐ that increase in productivity is not likely to be much faster in next generations than in the years following the wars, and
- ☐ that public policies for resisting inflation will not be more energetic in the future than they have been during the past decades or two.

But before examining the effectiveness and success of the policy implications, we shall discuss the causes that accounted for creeping inflation during recent years:

- ☐ Excess demand for goods and services, i.e. demand pull inflation.
- ☐ Excess demand for labour due to increased effective demand, i.e. cost pull inflation.
- ☐ Excess negotiated wages as an independent force, i.e. "wage drifts" or "mark up" wages and wage "differentials".
- ☐ Monopolistic prices and profits, i.e. "administered prices" or "mark ups" by the entrepreneurs.

### **The Wage Push Argument**

These causes interact with each other and can seldom be completely isolated. Some writers have taken an extreme position in ascribing full responsibility to some particular cause, but recent experience shows that there has been more than one cause for rising prices and that relative importance of causes has differed from country to country and from time to time. The wage push argument is a tricky one, full of pitfalls. It is an undoubted fact that, if wages were held constant, any inflationary gap would quickly vanish. Consumption would, under these circumstances, be held constant—indeed in real terms it would decline. No society can experience inflation for long, if it firmly holds the wage line. This

is certainly true. One may say that the wage level or rather efficiency wage level is the backbone of the price level; it is the pivot around which the price structure is built. Prof. J. M. Keynes put it succinctly as follows: "The general price level depends upon the level of wage rates and scale of output. And both wage rates and output are affected by changes in aggregate demand."

We are often told that money wage rates since the end of the second world war have risen more rapidly than man-hour productivity; this proves therefore conclusively that wages are the cause of the post war inflation. Wage increase regularly exceeds productivity increase by the amount of price level. But such correlations of statistical series only pose problems. It may quite well have been the other way round: i.e. price and profit increase causing wage increase in excess of the productivity gain. Statistics show that profits have gone up in the USA as well as in other industrialised countries of Western Europe. In economies in which monopolistic prices prevail, profit margins can be too high in many senses. In a competitive economy high profit margins, however, simply reflect heavy demand exerted in markets. The high profit margins provide both means and motivation for capital investment to increase supply and as supply catches up with demand, profit margins tend to decline. Conversely, when demand is so strong relative to supply that prices move upwards, profit margins tend to widen. But it is the excess demand that creates the inflation and not the widening of profit margins.

### Causal Relations

The study of such relationship is significant from a policy standpoint, because it shows the need to prevent firmly excess demand, particularly because excess demand and labour scarcity often affect prices through their effects on wages. This relation of demand to wage increase explains the price-wage spiral, money-wage illusion and the wage-wage spiral. But apart from this causal relations, which vary from country to country depending on the unemployment level, the OECD Council's Group of Ten agreed that excessive wage increase through negotiation has been a significant factor in the upward movement of prices. In general it can be said that the stabilisation authority must have a wage policy for dealing with the problem of wages just as they have monetary and fiscal policy. Though while having such "guide-posts" for wages, one has to think that wage negotiations and pricing practices relate not to average wage rates and average prices but to wages and prices in specific industries, where wage push inflation tends to develop.

Governments committed to national wages and price policies would have to be involved in rather extensive regulations relative to individual wages and prices, and in these circumstances political considerations and usual group pressures will have their fair play.

Whatever may be the causal correlations amongst these variables, it still remains a conclusive fact that these economies have become now inflation-potential economies. The economies in which "conspicuous consumption" of what has been described by Prof. Galbraith's "Affluent Society" on the demand side and the profound influence of "techno-structural corporations" are bound to experience such spasms of expansionary trend, tend to have no more automatic market mechanism to keep them in equilibrium.

### Inflationary Trends in Developing Countries

The developing countries as against developed industrial countries are characterised by the following basic structural differences:

- ☐ Predominantly agricultural countries subject to low per capita income.
- ☐ High population explosion, causing pressure on land and reducing productivity, resulting in what is known as "disguised unemployment".
- ☐ Scarce capital and little technical know-how.
- ☐ Very low private savings due to low income, or in other words, a "vicious circle of poverty".
- ☐ Problems of unemployment and underemployment.
- ☐ Low marketable surplus.
- ☐ A big non-monetised sector.

Governments of these countries have started with big development plans with a special emphasis on heavy industries, considering it a magic rod for becoming rich in a short period. But this attitude has created many complicated economic problems and inflation is one of them.

The bottleneck of capital can be overcome, if ex-ante investment is undertaken at a level sufficiently in excess of the current rate of savings. Investment per-se is capable of generating additional incomes, which are capable of providing the required savings in the ex-post period, but this process does not work in developing countries as expected, because the general level of consumption is on subsistence level in rural areas and therefore additional income does not constitute savings but is used in consumption. In urban sectors of the economy this additional income manifests itself as demand for consumers' durable goods and amenities, which is not met with additional supply of these goods, as the planned investments go into the large and heavy projects of a longer gestation period. A further factor is that government expenditures and investments in heavy industries by deficit finances and foreign credits generate monetary increase in income without producing goods immediately.

### Prime Cause of Inflationary Trends

The crux of the problem is that income generated by heavy investments in "machine tool sectors" is not sufficiently met by the proportional increase in

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manufactured consumer goods and so there is seemingly excess demand relative to supply. There is a wide range of "wage-goods gaps" in the rural sector and scarcity of durable consumer goods in the urban sector which cause prices to rise. Low productivity in agriculture, low marketable surplus, bad harvests and imports of food grains as well as machinery and raw materials, all these factors unitedly affect the supply and cost of production which is the prime cause of inflationary trends in these countries.

Furthermore the business class and the middle income group i.e. the salaried class of the urban areas are, apart from the private big industrialists, the most affected sections of the population by planning and they are the lucky ones to gain the planning profits. The rise in monetary income of these classes, however, does not constitute any productive savings in real terms as this income finds its way into Duesenberry's "Demonstrative Effects"; viz. "when incomes rise, the populace attempts to emulate western and more specially and specifically American standards of living". The lower income groups try to imitate the higher standard of living of the people belonging to the upper income groups. There are many examples of such consumption such as lavishly furnished flats for housing, radios, transistors, refrigerators, cars, etc. Manifestation of such demand shifts investments in such sectors of the economy where such durable goods are produced. Mostly the private businessmen and industrialists engage themselves in these sectors and earn monopolistic profits. Production of these goods involves foreign skill and foreign raw materials which in turn increase the cost of production and limit the supply. This results in "wage-price inflation" or "cost-push inflation" and "supply-scarcity inflation".

On the other hand this phenomenon diverges scarce resources away from the priority to the non-priority sectors and aggravates the situation by creating pressures on "basic goods sectors", upsetting interrelationship of prices, increasing inequality of incomes and establishing wrong patterns of investments which in turn degenerates savings propensity of the people.

To add to these purely economic factors responsible for inflation in developing countries, there are random factors like heavy investments for defence purposes, high administrative expenses, foreign debt, adverse balance of trade and deficits in the balance of payments, and last but not least bad harvests and natural calamities like draughts. PL 480, under which food grains are imported from America, in fact affects adversely the agricultural growth in these countries. Often it is used to fill the gap without stimulating any improvement in agricultural productivity.

#### **Policy Implications**

The prospect of continuing inflation in modern industrial countries of the western world is indeed a

new one in the sense that it has arisen from the forceful actions of the governments to maintain full and high employment. Rising prices or even any serious threat of rising prices generally mean that in practice the process of steady growth based on high employment is subject to shirks and interruptions. It follows from this that for steady growth without any wild oscillations, the choice should be made between varying degrees of unemployment and inflation — the famous "Phillips Curve Relationship". The other suggestion on a similar line was made by Prof F. W. Paish, London. He suggested that some margin of unutilised capacity should be kept in the economy, so that output can be accelerated with a proportionate increase in income in order to keep prices constant. But in economies, where inflation already prevails, it becomes difficult to create any unused capacity. There are wide varieties of diagnoses and even wider varieties of prescriptions for curing inflation. The policy of "Stop-Go" adopted by the UK appeared to be reasonable in times of galloping inflation but it posed problems of recession and serious deficits in balance of payments. Thus the question of policy judgement becomes controversial and difficult particularly because of the complicated structures of the modern industrial economies. These industrial economies are subject to "overheating" in order to absorb the latest technology and they are increasingly influenced by oligopolistic and monopolistic forces with seller's markets, which causes wage-wage and profit-push spirals.

The success of monetary and fiscal policies to combat inflationary spirals lies in this situation in the prudent and prompt co-operation and better understanding between government and entrepreneurs, labour and enterprise and finally trade unions and governments.

#### **Corrective Measures in Developing Nations**

The solution for developing nations lies not in corrective measures in monetary and budgetary policies as such, though these policies are also important as far as the urban class is concerned. For the general policy it is necessary to change the whole development strategy by shifting the priority investment pattern in agricultural and basic goods, as well as other small scale industries providing manufactured goods and services. A blanket reduction in consumption is least desirable. Monetary policy affects a small section of the population in these countries as there still exists a big non-monetised sector in rural areas. Selective sections of populations as industrialists and mini-millionaires plucking monopolist profits should be brought under budgetary policy of heavy taxation, of course with thoughtful exemptions for productions such as export-oriented plants and industries supplying basic goods for immediate consumption. And finally capital formation should be designed from within and not from outside, so as to avoid foreign debts as far as possible, until these countries reach a matured stage for absorbing foreign automatic techniques.