Causes and impacts of inflation on developing countries

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Introduction

Economic development in low developed countries is a contested argument amongst economists, all of which are looking for the best way to enact economic growth. The discussion surrounds whether stable monetary policy will encourage economic development by encouraging foreign direct investment or will currency depreciation and inflation create the right environment for exports growth and thus economic growth? This essay will discuss the causes of inflation and its repercussions for economic growth in developing nations. The argument for monetary stability and its repercussions for economic development will also be discussed. The scenario surrounding the Asian financial crisis will be used at the conclusion of the essay to illustrate the finer points in the argument for monetary stability as a means to economic development.

The Causes of Inflation

Krugman and Obstfeld define inflation as the increase of prices of goods [1] . There are arguably many causes of inflation; it is a complex combination of many macroeconomic variables that work together to increase the price of consumer goods in a developing economy. Shamsul, Shyam and Kamath discuss, there are two dominant hypotheses regarding the causes of inflation; the monetarist hypothesis and the structuralist hypothesis. The monetarist hypothesis refers to an increase in the money supply which in turn causes an increase in the price of goods and the structuralist hypothesis refers to structural characteristics of a developing economy creating inflation including the nature of the tax system, foreign exchange restraints, the

budgetary process, the nature of the labour market and administered prices. All result in a devaluation of domestic currency on a global currency market [2] . The forces that result in an increase in the money supply or a devaluation of domestic currency against foreign currency will discussed.

Common economic theory states that liberalisation of financial and capital markets in developing countries results in growth and stability in those countries. However Chakraborty discusses how unrestrained opening up of an economy can result in a foreign exchange crisis. That an inflow of foreign currency through investment and fixed exchange rates will result in higher reserves in the central base, which in turn results in more money existing in the economy which causes inflation. Inflation thus can be seen as a cause of the devaluation of a domestic currency on global money markets [3] . Developing countries will often use an export oriented economic strategy to increase growth. Devaluations of a domestic currency will make exports look more attractive on foreign markets; hence governments will try and keep exchange rates down. Chakraborty continues that as prices continue to rise the demand for money similarly rises by domestic residents. It is common for residents to sell foreign bonds in order to buy local currency, which in turn puts pressure on the currency to appreciate. In order to undermine this scenario banks will sell local currency and buy foreign reserves to counteract the appreciation of the exchange rate due to the increased demand. This scenario has a cyclical effect and will in turn increase the money supply and inflation [4] .

The situation surrounding a floating exchange rate can be quite different. Chakraborty discusses how liberalising the capital market will attract capital inflows from foreign investors which will increase the money supply, but will however appreciate the exchange rate. This type of policy will usually be accompanied by a contractual monitory policy that will increase demand for money and increase the interest rate. The increased interest rate will further attract capital inflows and further appreciate the exchange rate. An appreciated currency will be less attractive on foreign markets thus export demand will decrease and imports will increase, deteriorating the balance of trade deficit [5] . Large foreign debts result in a higher risk of financial instability.

Inflation and currency devaluations have been a common problem in the history of developing nations. Instability in prices and foreign exchange rates discourages lenders in richer countries from investing in poorer markets due to the threat of losing money in a financial crisis or currency devaluation. Krugman et al discuss how richer nations protect themselves against this risk by insisting that poorer countries repay their loans in the lenders currency. A transfer of wealth can be directed towards foreign lenders in the event of currency devaluation as it raises the local currency valuation of the debt. This scenario can lead to developing countries inability to repay foreign debts and sometimes in default [6] .

Inflation can be a result of external factors in a global economy including contagion from other trading partners. Cheng and Tan discuss that although domestic factors are important determinants of inflation, they are often not

as important as price volatility being transmitted from one country to another. In the case of Malaysia, interactions in the form of trade resulted in a causality of inflation from other ASEAN nations to inflation in Malaysia [7] . This form of contagion can be very influential for a developing country liberalizing its financial and capital markets in a global economy.

Instability and inflation can lead to speculation which in turn can lead to financial crisis. Krugman et al discusses contagion as the vulnerability of developing economies to suffer a loss of confidence in their financial markets which can cripple even the healthiest economies. Speculation regarding the devaluation of a local currency can result in investors pulling out of their investments (which now must be paid in the lenders currency), selling all the local currency (which has a further devaluing effect) and leaving the country with a large foreign debt. Speculation can be contagious as was seen in the Asian financial crisis where devaluation of the Thai Baht was followed by similar speculation surrounding other Asian currencies including that of Indonesia and Malaysia and eventually resulted in full financial crisis [8] .

Controlling Inflation and Stabilising an Economy

Methods used to counteract heavy speculation and financial instability includes information transparency. Ferreira de Mendonca and Filho discuss increasing information transparency as implying a fall in inflation bias and inflation volatility. Anxiety regarding inflationary pressures can be controlled through forecasts being released by the central banks of developing nations making policy and macroeconomic performance more predictable. There is

evidence that economic transparency can reduce inflation and lower interest rates thus improving the conduction of monetary policy [9] .

Wagner discusses inflation as being regarded as the signal of bad policy and political and economic instability. The variables are the relevant locational factors that determine the attractiveness of economies for investment. A loss in investors and mobile factors of production such as technology transfer and knowledge results in loss of potential production and potential output and hence growth. Local residents suffer through an increase in unemployment and a decrease in productivity [10] . Local economies become more unstable as a consequence.

It can now be deduced that managing exchange rates is paramount to controlling inflation in developing countries. Wagner discusses two methods of managing exchange rates in order to control inflation; the ‘ hard peg’ option and the floating currency option. The term ‘ hard peg’ refers to the currency boards, where monetary policy autonomy is completely given up. Hard peg exchange rate regimes have gathered a lot of interests for developing economies over recent years as currency crises are not possible under the hard peg system. There are certain preconditions for an economy that need to be present in order for a hard peg to be possible. The recipient developing nation must have a developed, well supervised and regulated financial system; the rule of law; fiscal discipline; and wage and price flexibility. Many emerging nations lack these preconditions and hence are unable to sustain a hard peg [11] .

Boyd and Smith suggest that low inflation is the central objective of developing economies in their efforts to enact economic growth. Growth is seen as having an inverse relationship to inflation and thus must be kept as low as possible. Developing countries in the Caribbean such as the Bahamas have been successful in lowering inflation and stabilising the exchange rate through using a currency board as part of their institutional structure. The currency board ties the monetary policy of the constituent countries and provides disciplinary controls on monetary and fiscal policy which in turn provides stability in their output. All the countries in the currency union experienced persistence however low rates of inflation and low variability in inflation rates therefore could be considered stable and an acceptable monetary policy performance [12] .

Wagner further postulates that a floating exchange rate is similarly effective in controlling high inflation. Despite anxiety that a floating exchange rate will result in an unstable currency, floating exchange rates can be used to attract foreign investment and thus appreciate the value of the currency. Interest rate and intervention policies can be used to influence the behaviour of the exchange rate and reduce the negative effects of speculation [13] . A floating exchange rate can be flexible enough to encourage investment through appreciation however encourage exports through devaluation provided controls are in place to ward off speculative attacks.

Maskooki shows Mexcio as having successfully implemented a floating exchange rate in order to control inflation. It reduced the value of the peso by gradual and frequent currency adjustments in reaction to market

conditions. The slow depreciation of the peso made exports more attractive overseas and was offset by the liberalization of the capital market which was attractive to foreign investors. The combination of the two had a balancing effect on inflation and exchange rates and thus encouraged stability of prices. This had made the external market less exposed to unexpected shocks [14] . Through economic stabilization Mexico is now less vulnerable to investment reversal and thus less vulnerable to financial crisis.

Stable inflation rates and exchanges rates send positive signals to global financial markets of positive financial policy in developing countries. Good corporate governance has the reflexive ability to create the positive economic environment to control inflation and also the positive outcome of successful monetary policy. Arsoy and Crowther comment that mandatory corporate governance can be achieved through the creation of capital markets in which transparency, accountability, responsibility and fairness are understood by both investors and shareholders [15] . Transparency being the proponent for fighting speculative attacks by reducing risks associated with investing in developing countries. Krugman et al discuss that governments of developing countries must create a stable environment through reducing the risk of inflation and protecting property rights in order to encourage economic growth. In protecting property rights they encourage private enterprise, investment, innovation and ultimately economic stability [16] . The conditions for economic stabilization feed off each other – stabilization encourages investment which in turn encourages more stabilization.

Nsouli, Rached and Funke discuss the control of inflation as paramount to the success of any domestic economy. Here again price can be seen as a signal of economic health as price liberalization is essential for the efficient allocation of resources within and

across sectors of the economy. Without a rational price system, profit and losses alone cannot signal what industries should expand and which ones should shrink. In both transition and developing economies, price liberalization led to a rapid increase in the availability of products for consumer use [17] .

The Asian Financial Crisis

The countries of the Asian economic boom in the mid 1990's are a perfect example of how unstable monetary policy can bring even the most impressively growing economy down. Krugman et al tells us the Asian tigers were initially South Korea, Hong Kong, Singapore and Taiwan and then Thailand, Malaysia and Indonesia later joined the group. They had achieved incredible rates of growth through high savings and investment rates, improving education levels amongst the work force and by liberalising trade or at least a high level of openness and integration with global markets. The Asian tigers were gaining popularity as an investment opportunity as restrictions on capital inflows were lifted. However all this investment was leading to large deficits and would eventually result in financial demise [18] .

Krugman et al continues that starting with the depreciation of the Thai Baht, a chain reaction of events brought the Asian miracle into financial crisis. A

sharp drop in the value of the Baht as it was left to float after being pegged to the American dollar brought about speculative attacks on the currencies of its neighbours Malaysia and Indonesia and eventually South Korea. All countries had large foreign debts mostly in American dollars and as a result were facing increasing values on these debts due to the decreasing exchange rate. Many debts in Asia had the power to push banks and viable companies into bankruptcy as a result of exchange rates spirally out of control [19] . The Asian financial crisis was seen as a self perpetuating scenario based around speculative attacks on currency valuations. Lee argues that as soon as a currency peg is seen as non-defensible market participants expect that the market will move in one direction and in fact it does. Once the expectation sets in collective action takes hold (in this case investors pull out of their investments) and the result can inflict financial ruin on whole economies [20] . The Asian miracle had come to an abrupt end.

Krugman further discusses the cause of such violent economic collapse can be seen through bad government policy. In Thailand and Indonesia ‘ crony capitalism’ was the source of a lot of poor investment decisions. The sons and daughters of royalty or prominent politicians were the recipients of a lot of investment money regardless of the legitimacy of the project resulting in considerable moral hazard in lending. The regulatory system was ill equipped to deal with companies in danger of bankruptcy or to foster quality investments in the economy that would count towards real growth [21] . As a result the first sign of instability caused foreign investors to pull out of investments and leave the economy in crisis.

The act of stabilising an economy is a complex process involving effectively monitoring the potentially volatile variables of an economy. Wagner discusses economic stability as being created through strengthening domestic banking and financial systems; providing better information and policy transparency; strengthening corporate finance, including bankruptcy laws and their implementation; taking precautions against potential capital flow reversals; and last but not least, building packages of sound macroeconomic and exchange rate policies [22] . Although the situation in South East Asia has improved over the years since the financial crisis, Low tells us that many questions still remain in Asia regarding their economic stability for the future, for example, whether effective democratic checks-and-balances in the political system, legal, judicial and institutional processes can help reinforce the moral economy [23] . It is fare to say that controlling inflation is but the tip of the ice burg when stabilizing a developing nation's growth.

Conclusion

Inflation and economic instability are a common problem for low developed countries trying to establish themselves in global markets. Inflation and currency depreciation are fundamental signals to wealthier nations that a local market is too big a risk to invest in thus leaving development and growth stagnant in those countries. Price stability on the other hand can signal to potential investors that a local financial market has strong monetary policy, that exchange rates can be controlled and that the local business environment is encouraging to growth. Countries with unstable

monetary policy are vulnerable to speculative attacks from market participants as can be seen in the case of the Asian Financial crisis. Pegging local currencies to stronger currencies such as the United States dollar can result in devastation if markets forecast a currency will be overvalued. Contagion can result in a chain reaction of events that brings trading partners into similar financial crisis. Although devaluing a currency can make exports more attractive on foreign markets it can also discourage foreign direct investment from investing due to the high incidence of default on foreign debt.

Mechanisms have been designed to control factors such as inflation and encourage foreign investment by richer nations. A floating currency or a currency board can be used effectively to stabilise exchange rates and thus control the flow of funds in and out of a local market. Good corporate governance including transparency of monetary policy can be used to reduce the risk of speculation and forecast inflationary activity. Political stability also needs to be created through effective regulatory systems on financial and capital markets including bankruptcy laws and laws preventing capital flight in the face of financial crisis.

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Footnotes

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