145

DEFICIT FINANCE AND DEVELOPMENT: AN ASPECT OF MONETARY POLICY IN DEVELOPING COUNTRIES

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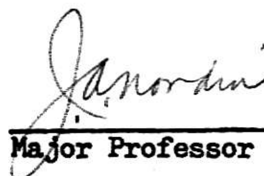

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TABLE OF CONTENTS

Page

I. Introduction 1

II. Monetary Expansion and Savings 6

1. The Optimistic Point of View 8

2. Optimistic View with Qualification 11

3. A Critical View 13

III. Effect of Inflation on Foreign Investment 20

IV. Effect of Inflation on Foreign Exchange Reserves 24

V. Concluding Remarks 27

Bibliography 30

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INTRODUCTION

The importance of monetary policy in economic stabilization has long been recognized in the developed nations. The long standing controversy in these nations has not been whether money "matters" in stabilization processes, but whether the contribution of monetary policy for short run stabilization is as significant as fiscal policy. There has long been an implicit tendency to minimize the contribution of monetary policy in raising the rate of economic growth and facilitating capital formation. In this context, the treatment given to monetary policy in its role as a stimulant of economic growth has been very sketchy. One finds such statements as "over the cycle, prices and output tend to move together," and that "a monetary change that provides vigorous (monetary) expansion is likely to promote a vigorous rise in both and conversely."[1] Such statements are qualified by conceding that, in the long run, a country's growth and development actually depends on such real factors as its technology, population, the skill of its labor force, and its endowment in natural resources.[2] Perhaps, the explanation for the existing ambiguity with regard to the specific role of money in growth processes may be found in what David I. Fand considers to be a dichotomy between monetary theory on the one hand and the historical and applied analysis of business cycles and stabilization processes on the other. "Monetarists follow the classical tradition in their theoretical analysis and treat the nominal money

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[1]Milton Friedman, "The Supply of Money and Changes In Prices and Output" in The Relationship of Prices to Economic Stability and Growth: Compendium of Papers Submitted by Panelists: U.S. Congress, Joint Economic Committee, Washington, D.C., 1958, p. 251.

[2]Ibid., p. 251.

stock as a kind of veil and stress that its influence is primarily on nominal variables, with very little permanent impact on real endogenous variables. But as they move from monetary theory into analysis of business cycles and stabilization policy, the money stock is somehow transformed into a powerful lever for determining income, employment, and the price level."[3] The belief that money primarily influences "nominal variables" and that the analysis of production and distribution can very well be undertaken even without its use permeated classical thinking, as is evidenced by John S. Mill's statement, "there cannot be intrinsically a more insignificant thing, in the economy of a society, than money; except in the character of a contrivance for sparing time and labor . . . it only exerts a distinct and independent influence of its own when it gets out of order."[4]

In recent theories, monetary policy is not treated so lightly -- especially in moderately shortrun analysis. The fact that it is offered as an alternative policy choice to fiscal action when there are disturbances in the real (non-monetary) variables suggests that money is expected to be more than a "veil". And the rate of growth of the money supply is duly incorporated in growth models along with other 'real' factors.[5] However, the supply of money, unlike other variables in growth models, is determined exogenously. There is always the danger of error of either over estimating or under estimating the right amount of money that an economy can usefully accommodate. If such an error is made, it may set off undesirable repercussions in the economy.

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[3]David I. Fand, "Monetarism and Fiscalism" Banca Nazionale Del Lavoro: Quarterly Review, vol. XXIII, No. 94 (September, 1970), p. 278.

[4]John S. Mill, Principles of Political Economy, Book III, ed. W. J. Ashley, New York: Longmans, Green and Co., 1929, p. 488.

[5]R.G.D. Allen, Macroeconomic Theory, London: Macmillan, 1967, ch. 20.