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ORIGINAL ARTICLE

The social consequences of inflation in developing countries

Jayati Ghosh

University of Massachusetts Amherst, Amherst, USA
Email: jghosh@umass.edu

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Abstract

The title of this article is a riff off a publication of G. C. Harcourt's 1974 piece, 'The social consequences of inflation'. He wrote this in a period of the global economy that bears some strong similarities to our own contemporary phase when inflation is suddenly back in the global headlines. There is at least one significant difference: at that time, Harcourt highlighted inflation as the outcome of an excess of total demand in real terms over available supplies of goods and services when the potential workforces and existing stocks of capital goods were fully employed. Current inflationary pressures, by contrast, arise from the combination of specific sectoral supply bottlenecks, rising profit margins in oligopolistic global markets for food and fuel and financial speculation in these markets.

Keywords: Harcourt; inflation; developing countries

JEL Codes: E12; E31; E44; F36; F42; O19

Introduction

This article is written as an appreciation of and homage to Geoffrey Colin Harcourt, whom I was privileged to have as my teacher and supervisor at the University of Cambridge, England, in the early 1980s. Geoff was not just an extraordinarily fine and learned economist who could express complex economic ideas in an approachable and clear form; he was also one of the most graciously civilised, warm, generous, and wonderfully engaged human beings I have ever met. He wore his vast scholarship lightly, and his innate (rather than assumed) modesty was a defining trait. Despite his many important insights that have enriched the economics discipline, he would always talk about others' contributions instead of his own. Listening to Geoff could make you forget that economics is characterised as a dismal science, as he would lace the conceptual discussions with his witty, always interesting, often humorous and sometimes salacious personal reminiscences. His enthusiasm for the subject and its varied practitioners (many of whom sadly did not share his strong ethical principles, modesty or generosity) was infectious. His life remains a shining example of a life lived fully and well, enabling joy and providing great benefits to others around him.

The title of this article is a riff off the title of an article that Geoff himself originally published in 1974, "The social consequences of inflation" (reprinted in Harcourt, 2001). He wrote this in a period of the global economy that bears some strong similarities to our own contemporary phase, when inflation is suddenly back in the global headlines. There is at least one significant difference, of course: at that time, Geoff highlighted inflation as the

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outcome of an excess of total demand in real terms over available supplies of goods and service when the potential workforces and existing stocks of capital goods were fully employed. This would be reflected in *ex ante* investment expenditure exceeding full employment saving, running down of stocks of goods, specific scarcities resulting in queues, lengthening order books and, of course, rising prices. He noted that the exact combination of these ingredients would depend on the market structures of specific economies.

The 1970s is now known as a period of global stagflation, and the containment of inflation was seen as a – perhaps *the* – central policy issue of the time. The discussions on the causes of inflation, including the (infamous) Phillips Curve that posited an inverse relationship between inflation and unemployment, reflected the specific political economy conditions of the time, particularly in the developed capitalist economies. In fact, inflation has always been about the struggle over distributive shares in an economy. The ability of workers, at least in many advanced economies, to battle to retain or increase their share of national income in the face of attempted increases in profit mark-ups clearly reflected bargaining conditions resulting from the near-full employment conditions that prevailed.

But subsequently, there was a long period when inflation seemed to drop out of the policy discussion in advanced capitalist economies and did not seem to be much of an issue even in many low- and middle-income countries (LMICs). This was the period that has been described as 'The Great Moderation"' (Bernanke, 2004), roughly between the mid-1980s and the years leading up to the global financial crisis of 2008: when fluctuations in economic activity in the developed world were reduced and less severe, and when inflation rates were low and sometimes even negative in many economies. Of course, this was not the case in all parts of the world: some countries experienced very rapid inflation in certain years (such as Russia in the early 1990s, or the Democratic Republic of Congo, or Venezuela) or even hyperinflation (like Zimbabwe).

The recent concern with inflation is a global phenomenon, affecting all countries to varying degrees, with generalised price rises above the levels of the past four decades in every region and some economies already experiencing hyperinflation. For many economists, this has reinforced existing prejudices (which can no longer be glorified with the name of 'theories') about the role of money supply in causing inflation. Across the world, the policy remedy being advocated and applied is that of tighter monetary policy, expressed in either reduction of central bank-generated liquidity or higher central bank interest rates, and typically both. This policy response stems from a basic misunderstanding of the nature of the current inflationary phase. It is argued in this article that this is an outdated and fundamentally misconceived policy response, which will have extremely debilitating effects on real economies and lead to enormous suffering, not only in the advanced economies where they have been first applied but also across the highly integrated world economy.

The nature of inflation

Inflation refers to a general increase in prices – not just in specific goods and services but an all-round increase that is spread across different sectors. It matters to ordinary people particularly when their money incomes do not go up as fast as prices do, which then results in the loss of their purchasing power. This is described as a decline in real income or real wages, which can happen even when money incomes are increasing.

The debate on the causes of inflation has divided economists and policy makers for at least a century if not longer. Traditional monetarist economists have tended to believe that inflation results from excess money supply creation: 'too much money chasing too

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few goods'. They argue that increases in credit creation or 'liquidity' would result in higher inflation rates, since the level of economic activity by real supply which is determined by other factors. So the way to control inflation is to limit the creation of credit in an economy, by curbing the expansion of 'reserve money' or the currency case, reducing credit to government and limiting banks' ability to extend credit. According to them, this would reduce the amount of money in circulation and thereby force prices down.

There are at least two basic conceptual flaws in this argument. The first is the idea that the total economic activity (or supply) is given exogenously, by available labour and institutional factors, so that it cannot be affected by macroeconomic policy. Instead, since most economies are not at full employment, macroeconomic policies can affect the level of economic activity. The second flaw is the idea is that the total money supply is a stock that can be fixed by policy. In reality, governments can affect only the base or reserve money and some of the credit provided by the banking system. In general, once that is determined, economic activity determines the actual amount of credit or liquidity in the system, by changing the 'velocity of circulation' or the number of times the base money directly or indirectly changes hands through different transactions. So the final supply of money or liquidity in the system is an *outcome* of the economy's functioning, not a policy variable in the hands of the central bank or the government. What the central bank can and does do is change its base interest rate, which is the floor for all other interest rates in the economy.

That is why other economists, especially those with Keynesian and structuralist perspectives, take a completely different view on the causes of inflation. In the Keynesian approach, inflation reflects the excess of spending over income at the macroeconomic level. This imbalance can result in either a balance of payments deficit or domestic inflation. This means that if there are supply constraints or bottlenecks that prevent output from rising when there is more demand for goods and services in the system, , that can cause inflation.

Structuralists point out that inflation results when different groups in the economy fight over their shares in national income: firms, workers, agriculturalists and other primary producers, and governments. For example, if imported input costs rise, firms may try to increase their output prices to maintain their profit margins. But if workers who feel that their real wages would fall as a result of this are able to fight to increase their money wages, then that adds further to costs and firms could seek to increase prices further as a result. This can lead to an upward spiral if both groups are able to seek to maintain their real incomes. This is more likely when such groups are stronger, and if more incomes are 'indexed' to the inflation rate, as is sometimes happens when unions are able to build this into their wage bargains, or when businesses are able to insist on maintaining their profit margin by raising their prices. In other words, inflation is essentially the result of the conflict between different groups over distributive shares of national income (Maynard, 1962; Rowthorn, 1977).

High inflation rates are obviously very destabilising, but they can reflect the ability of more sections of the economy to fight back to at least maintain their real incomes. When expectations of inflation become more widespread, all groups who can do so try to raise their own prices so as not to lose out in real income terms. This can generate inflationary spirals because such expectations become self-fulfilling.

By contrast, in economies (particularly many LMICs) with a large proportion of informal and non-unionised workers with little or no bargaining power, such increases in production costs and prices just get passed on to workers who are not able to demand higher money incomes as a result. This means the inflation rate may remain relatively lower, but it would have possibly a worse impact on living standards as real incomes fall.

Different inflationary episodes can be classified according to whether they are 'demand-pull' or 'cost-push'. The distinction is important because it should affect how governments

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respond. Demand-pull inflation is when the money demand for goods and services rises too fast relative to available supply (sometimes called 'overheating'). Usually, this is seen to call for a rise in central bank interest rates or tighter monetary policy that will make it more expensive or difficult to access credit, thereby reducing spending. Cost-push inflation can result from specific costs going up, possibly because of supply bottlenecks in specific sectors, or rising prices of imported inputs (either because of world price changes or exchange rate depreciation). In this case, raising interest rates will not address the cause of inflation but instead can cause economic activity to decelerate and even decline.

Controlling inflation depends fundamentally on understanding its causes, which vary by context and period. Tighter monetary policy is an excessively blunt tool that carries with it the real possibility of generating recession and unemployment, and thereby harming workers even more than the price increases. It is often argued that this is necessary to reduce the excess demand that is causing prices to rise. But this strategy, besides causing more suffering, need not even resolve the inflationary problem if the drivers of price increases are elsewhere and continue to persist. In the worst case, this policy can generate stagflation: the combination of slow or falling economic activity and rising price levels.

The recent inflationary phase

The period from the global financial crisis to 2021 should have conclusively refuted the monetarist argument that just releasing liquidity into an economy will generate inflation. Since that crisis, just four major banks (the US Federal Reserve, the European Central Bank, the Bank of England, and the Bank of Japan) released unprecedented amounts of liquidity, such that their total assets increased from around $4 trillion in January 2008 to more than $26 trillion in 2021. (United Nations, 2022) But throughout this entire period, until mid-2021, inflation rates remained low in the advanced economies, declining and even turning negative in some countries.

After decades of declining and low inflation, and a recent phase when there were even absolute falls in price levels that became a source of concern for some governments and central banks (such as in Japan), inflation became a concern once again in 2021 (Ha et al., 2021), and showed notable acceleration in 2022. Yet in this recent inflationary phase, most economies in the world – and even most advanced economies – did not exhibit the near full employment conditions that were evident in the early 1970s. Indeed, after the ravages of the COVID-19 pandemic, only the US economy had a relatively vibrant labour market, assisted by the truly massive stimulus packages provided by the administrations from mid-2020 onwards. This has been much more clearly a cost-push inflation in most countries, driven by increases in world trade prices of essential raw materials and intermediate products.

Globally, prices of essential commodities such as food grains and fuel or energy, which enter directly into prices of all other goods and services, increased from the middle of 2021, and accelerated very sharply from March 2022. There were specific supply chain issues that originated in COVID-19-related lockdowns and closures. Then, the Ukraine war made matters much worse, by affecting oil, wheat, and fertiliser supplies and impacting on certain established trading routes. Advanced economies experienced rates of overall inflation that were higher than in decades – but these individual cost-push factors were still not enough to explain the significant rise in prices. This was also driven by corporate profiteering and accelerated by financial speculation in commodity futures markets. Oil companies have seized the opportunity to push up prices beyond what is justified by their own cost increases (just like Big Pharma companies profiteered from the COVID-19 pandemic). Meanwhile, financial activity in commodity futures markets increased

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substantially between January and March 2022, driving up futures prices in wheat and other commodities and so affecting current spot prices as well.

This pattern was clearly evident in the USA. In the three decades 1979–2019, when inflation rates were not so high, rising unit labour costs (which reflect rising wages) contributed to 62% of the total price increase, compared to 27% because of other input price increases and 11% because of more profits. But in the recent and ongoing inflation, the ratios have been reversed (Bivens, 2022). Increasing corporate profits contributed disproportionately to recent inflation. In the period from the second quarter of 2020 to the last quarter of 2021, corporate profits were responsible for 54% of the overall inflation. By contrast, unit labour costs were responsible for less than 8% of the inflation, compared to 62% in the previous four decades. The contribution of non-labour input costs – the famous 'supply chain issues' that have been so widely advertised – was 38%, compared to 27% in the earlier period. Indeed, workers in the USA have not gained out of the recent process: because of the recent price rises, the real value of the federal minimum wage in mid-2022 was at its lowest point in 66 years (Cooper et al., 2022).

It could be argued that the ability to raise profit margins is itself because of higher demand. Certainly, just in the USA, pent-up demand from households unable to spend much during the pandemic could have had an effect, especially given the very large fiscal stimuli by successive US administrations. But a much larger role was played by growing concentration and monopoly power in industry. Massively increased corporate profits were most evident in energy, food, and pharma sectors, as the supply shortages resulting from the Ukraine war became convenient excuses for disproportionate price increases. It has been shown (Konczal & Lusiani, 2022) that firms in the USA increased their mark-ups and profits in 2021 at the fastest annual pace since 1955, such that both were at their highest recorded levels since the 1950s. Pre-pandemic mark-ups were a strong predictor of mark-up increases in 2021, making market power a significant driver of inflation.

Similarly, contrary to the general public perception that the current food crisis is all about war-related supply shocks, company behaviour was more significant. The major grain trading agribusinesses experienced dramatic increases in profitability in January–March 2022 as they raised their prices without being questioned, as everyone assumed that this was the result of war-driven supply shortages. Meanwhile, financial speculation, such as in wheat futures markets, drove up prices even in spot markets. (Incidentally, the recent decline in wheat prices similarly reflects changes in futures contracts. This is typical of speculative bubbles, which are often driven by news, but also tend to be affected by herd behaviour that intensifies particular tendencies even if they are not warranted by any real processes.)

The increased speculative activity is confirmed by research tracking the activities of financial investors (investment funds in particular) in commodity markets (Agarwal et al., 2022). This found that, for example, 'in the Paris milling wheat market, the benchmark for Europe, speculators' share of buy-side wheat futures contracts has increased from 23 per cent of open interest in May 2018 to 72 per cent in April 2022'. Similarly in May 2022, speculators' long positions (buying positions) constituted over 50% open interest in Hard Red Winter and Soft Red Winter wheat varieties. Similar trends were already evident in energy markets: one study (Heather, 2021) found that trading volumes at the European Union natural gas market's primary gas-pricing hub, the Title Transfer Facility, increased steadily over the past decade from 14 times actual gas consumption in 2011 to more than 114 times in 2020.

The chaos that such speculation can cause was evident in March 2022, when a dramatic spike in nickel prices forced the London Metal Exchange (LME) to suspend trading and cancel all deals. Over-the-counter (OTC) trades that occur outside the regulated exchange were held partly responsible, and the LME will now require all traders to report their OTC positions on all physically delivered metals each week. Prices in other commodity derivatives markets

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remained highly volatile through 2022, as hedge funds and other financial firms rushed out of different index and commodity funds as rapidly as they piled in.

This matters hugely because food, fuel, and basic metals are essential for production and for life itself. Commodity-price volatility affects living standards and the ability to produce goods and services and is contributing to the stagflation and hunger now stalking most LMICs. A very similar process occurred over 2007–2009, when oil and food prices first rose sharply and then declined to earlier levels in the space of 18 months, causing economic devastation across much of the developing world in particular (Ghosh, 2010). After that experience and in the aftermath of the 2008 global financial crisis, both the USA (through the Dodd-Frank Act) and the EU sought to regulate commodity derivatives to some extent. However, these regulations have proved inadequate and been allowed to be circumvented through the actual rules that have provided ample space for speculative activity to continue.

The impact on developing countries

Food and energy costs enter into all other prices and therefore directly and indirectly affect consumer prices – and this effect tends to be even stronger in LMICs where food in particular is a larger proportion of average household budgets and where governments typically lack the fiscal space to provide adequate counter measures to alleviate hunger. In most LMICs, food items still constitute between one-third to one-half of the consumption basket, particularly among the bottom half of the population that is already poor. And because energy prices necessarily enter into production and distribution of all goods and services, energy-importing countries are also very badly affected.

The impact this has on food security and hunger in LMICs is particularly severe. Even before the latest onslaught of global food and fuel price increases catalysed by the Ukraine War, a large part of the world could not afford a minimally nutritious diet. Estimates by the Food and Agriculture Organization (FAO) suggest that in 2020, even before the impact of the latest food price increases, the cost of healthy diets exceeded food expenditures in most countries in the Global South, such that as many as 3 billion people globally lacked sufficient income to purchase the least-cost form of healthy diets recommended by national governments (Herforth et al., 2020). These diets were unaffordable for the majority of the population (57%) in sub-Saharan Africa and Southern Asia, as well as high proportions of people in Southeast Asia (>45%), Melanesia (>40%), and Latin America (>20%). In some countries of sub-Saharan Africa, more than 80–90% of the population could not afford the basic nutritious diet, while in India the proportion was above 70% and in Pakistan above 80%.

What is more significant is that in such countries, prices have continued to rise even after global food and fuel prices went through the different phases of the speculative bubble and burst and reverted to levels of the pre-Ukraine War period. The problem of rising costs of imports, and particularly food and fuel imports, was worsened by exchange rate devaluations that add to the impact of higher global prices. This is one reason why domestic retail food prices in many LMICs tend to rise as world trade prices go up (even if only for speculative reasons) but do not necessarily decline as world prices fall (Chandrasekhar & Ghosh, 2022). Currency depreciation that affects prices of imported food long with price ratchet effects in domestic markets determine this process. While the FAO's global food price index peaked in March 2022 and fell thereafter, such that by August 2022 it was down to the levels of January 2022, the later recent declines in global prices were not matched by equivalent or even similar declines in most countries of the Global South.

Currency devaluation in many LMICs in turn was the outcome of much greater openness of the capital accounts of such countries, after a process of financial deregulation since the early 1990s. Neoliberal economic reforms were oriented to the now-familiar

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reliance on export-led-growth, to be supported by foreign capital inflows. This led to a significant increase in external debt over time in many 'emerging markets' and even 'frontier markets', a process in which the International Monetary Fund and the Davos World Economic Forum crowd were active cheerleaders. The macroeconomic policy response in advanced economies after the global financial crisis of 2008 involved massively increased liquidity and incredibly low interest rates in the advanced economies. In a world awash with liquidity, the search for higher financial returns meant that more funds flowed to 'emerging' and 'frontier' markets through credit and bond issues. While this was actively encouraged by the international financial institutions, it was always a problematic process that was likely to end in tears.

Monetary hierarchies in the global economy mean that capital leaves LMICs much more quickly at the first sign of any problem. And these countries were much more battered economically by the COVID-19 pandemic. Advanced economies were able to provide massive countercyclical measures, especially significantly increased fiscal spending, because financial markets effectively allowed and even encouraged them to do so. By contrast, LMICs faced significant declines in export and tourism revenues, tighter balance of payments constraints, and greater difficulties in accessing much more volatile external capital. They were prevented from increasing fiscal spending by much because of those same financial markets, because of debt overhang and potential capital flight. As a result, their economic recovery has been much more muted and economic conditions remain mostly dire. Then, the Ukraine war and related profiteering by big corporations made matters much worse especially for food- and fuel-importing countries, by generating inflation. The sad truth is that once 'investor sentiment' moves against LMICs, it tends to respond regardless of the real economic conditions in specific countries, as we have seen over and over again in different episodes of crisis since the 1990s. Private credit rating agencies amplify the problem. This means that 'contagion' is all too likely, and it will affect not just economies that are already experiencing difficulties (some of which have already been identified by the IMF and private agencies and therefore already facing capital flight and more stringent borrowing conditions) but a much wider range of LMICs

The half-hearted attempts at debt relief like the moratorium on debt servicing in the first part of the pandemic only postponed the problem, pushing the can (of worms) down the road and allowing the can to get bigger as it rolled. There has been no meaningful debt restructuring at all, even though it is essential. The IMF has continued to bewail the situation but does almost nothing, and both IMF and World Bank add to the problem through their own rigid insistence on repayments and the appalling system of surcharges imposed by the IMF. Meanwhile, the self-proclaimed leaders of the world, G7, and the associated 'international community' have been missing in action.

As a result, developing countries have faced multiple whammies – not only from the pandemic and the Ukraine war-induced commodity price hikes but also from capital movements that have intensified downward pressures on their currencies and made imports more expensive in domestic currency terms and added to external debt distress. All this, combined with decelerating economic activity, has put further pressure on fiscal space, to the point that it has been estimated that 85% of the world's population live in the grip of austerity measures in 2023 (Ortiz & Cummings, 2022).

The way ahead for developing countries

This suggests that the current macroeconomic policy responses to inflation in the advanced economies, which are all about tightening monetary policy and raising interest rates, are wrongly directed. They do not address the real causes of this inflation. They are more likely to cause economic recessions and will also generate more financial volatility.

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LMICs will once again be the worst affected, as they will experience capital outflows in addition to all their other current woes.

If recent global price increases – which then translate into inflation of varying extent in different countries – are driven by factors outlined above, then surely the policy response should be very different from the blunt tool of aggregate monetary policy. It should instead focus on regulatory action to curb monopoly power and financial speculation. Taxation of excess profits could be a deterrent to such behaviour in future, but specific actions to control prices of strategic commodities also have a role (Weber, 2023). Those who have pilloried such policies appear to be unaware of both history and wider experience.

In the aftermath of the 2008 global financial crisis, both the USA (through the Dodd-Frank Act) and the EU sought to regulate commodity derivatives to some extent. But these regulatory changes did not go far enough and were then watered down. Existing EU rules help to prevent market abuse on official exchanges by limiting individual traders' positions, but they still allow OTC commodity trading, enabling excessive speculation to continue. The USA prohibits OTC trading in most commodities, but financial agents can still enter the market through proxies. And position limits have been kept so high that they do not prevent large bids from influencing prices. As a result, financial speculation in essential commodities in the major trading exchanges of advanced economies can still play havoc with people's lives and livelihoods across the world.

Ideally, the regulations should have prevented speculation by ensuring that all trading occurs on regulated exchanges, not on an OTC basis, and in a transparent manner with full information about the actual players and their bids. Furthermore, exchanges should allow only those with a direct operational interest in commodities to trade them. (For example, an airline company should be permitted to operate in the futures market for aviation fuel, but a hedge fund should not.) And market participants should adhere to limits on the positions that they can hold, depending on their real use, need, or production of that commodity.

Instead of mimicking developed countries' ineffective approach to containing inflation, developing and emerging countries must introduce policies tailored to their specific needs and political economies. Such policies include controlling the prices of key commodities, increasing domestic production to alleviate critical shortages, and ensuring social protections for the newly unemployed and those who are worst affected by high inflation.

While short-term responses to inflation are necessary, in the medium term, the response to monetary policies in the advanced nations must be regulation of cross-border flows. Developing countries must introduce more effective capital controls. Imposing constraints on volatile portfolio flows, particularly those that contribute to currency depreciation, is crucial to mitigating the risks associated with financial globalisation. Controls on both outflows and inflows are unavoidable to reduce vulnerability. In other words, to contain inflation that hurts the poor in all countries, without worsening their conditions through anti-inflationary policies that destroy livelihoods and reduce employment, it is necessary to move beyond the straitjacket of failed policies that rely only on the monetary lever.

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