CHAPTER III

GOALS OF MONETARY POLICY - DEVELOPED AND UNDERDEVELOPED COUNTRIES.

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CHAPTER III

GOALS OF MONETARY POLICY: DEVELOPED AND UNDERDEVELOPED COUNTRIES.

Introductory:

Having stated broadly the developments in monetary theory and policy in the foregoing chapter, we should now turn our attention to understanding policy at (i) an abstract level trying to bring out the nature of monetary policy per se and in relation to general economic policy or to another component of it (say fiscal policy) and (ii) at the more practical level of examining the goals that monetary policy is normally being designed to serve. This will conveniently afford us an opportunity to state the role of monetary policy in the developed and underdeveloped countries in terms particularly of the differences in goals that may follow from some of the peculiar differences (institutional and policy-induced) between these groups of countries. An outstanding difference that may strike us, at the foremost, is the nature and role of monetary policy as being influenced and conditioned by other policy measures, in particular the policy of planned economic development pursued by some of the underdeveloped countries.

Doubtless the issue of a choice between monetary policy and fiscal policy does arise in the developed countries also but the problem of choice is more obvious in the case of underdeveloped countries in view of the institutional differences and pursuance of a deliberate policy of rapid economic development. Thus it has, for long, been argued that fiscal

policy is a more direct and powerful measure for resource mobilization while monetary policy is an indirect and feeble instrument for such a purpose. The issue boils down to the question of having an optimum policy mix, but we have so far not been able to evolve a plausible theoretical framework of optimum monetary-fiscal policy although both the Radcliffe Committee (in terms of its Package Deal approach) and the Commission on Money and Credit (in terms of its policy mix approach) have hinted at some practical solution of the problem. It is pertinent in this connection to note the attitude of the officials of the Reserve Bank of India who have times without number and unequivocally stressed the 'fiscal bias' or 'fiscal constraint' in the formulation of monetary policy in India implying thereby that monetary fiscal policy mix in India has remained sub-optional in character.[1]

QUANTITATIVE AND QUALITATIVE NATURE OF ECONOMIC POLICY

"Economic Policy" as Tinbergen points out "consists of the deliberate manipulation of a number of means in order to attain certain aims."[2] If we define Economic Policy as the gamut of all known and hitherto practised types of policies, monetary policy becomes a part of it and it is logically necessary that various policy components of 'Economic Policy' should be a coherent whole. How far it can be rendered into a 'coherent

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1. for instance as L.K.Jha, Ex-Governor put it "Monetary Policy in many developing countries has to be operated alongside budgetary defecit and the budget is often the senior partner". - International Seminar on Banking and Development - Reserve Bank of India, Bombay (1970) P.196.

2. J. Tinbergen "Economic Policy - Principles and design" (1963) P. 6.

whole' depends upon the aims that policy seeks to attain. If the list of aims is wider and there arises inconsistency in fulfilment of the aims a 'trade-off' has to be struck between two policy components or between aims themselves. In the terminology used by Tinbergen, aims may be called the Targets or Target variables and one can make a distinction between 'fixed targets' and 'flexible targets'. Policy formulation is rendered more difficult in the context of a flexible target than in the case of a fixed target. Thus a fixed target is one which is easily quantifiable (say the target of 'avoidance of unemployment' i.e. keeping the economy at an employment level, with not more than 3% unemployment). On the other hand, a flexible target such as the target of 'maximum real income per head' is one where it is left to circumstances what that maximum would mean numerically.[1]

The target variable or variables would thus lay the goal function of policy for the attainment of which, means or 'instrument' variables will have to be considered. In regard to monetary policy thus we might say that given the target variable(s) of full employment and/or price level stability as the goal function 'money stock' and/or 'interest rate' changes would serve as instrument(s).

The logic of economic policy according to Tinbergen is the inverse of the logic of economic analysis. In the latter

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1. Another analogous case is to be found in 'Some contribution, implying a margin in the balance of payments, to the economic development of the outside world' as one of the aims of monetary policy stated by the committee on the working of the monetary system - (Radcliffe Report) - P. 22.

the data (including the 'means') are known, while the economic phenomena (including the 'aims') are unknown. In the former however the 'aims' are known or well presumed to be known while the 'means' are unknown.

Another dimension of policy making according to Tinbergen inheres in its Quantitative and Qualitative aspects. Quantitative policy is concerned with (given the aims) bringing about variations in the 'numerical values of the instruments'; is the least ambitions type of policy and is most frequently applied for quick adaptations. Qualitative policy would on the other hand consist in bringing about a 'change in underlying structure'.[1]

It may also be noted following Tinbergen that "while qualitative changes in most cases also affect the quantitative aspects of the economy, quantitative means do not, as such, change the qualitative situation although they may lead to qualitative changes".[2] In an underdeveloped economy undergoing structural changes this relationship could not be ignored and more so when 'quantitative' policy making has often to proceed alongwith propositions for 'nationalisation' or development of financial institutions.

CONSTRAINTS ON MONETARY POLICY (GENERAL)

In the literature on monetary theory and policy a reference is often made to constraints on the working or

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1. "By qualitative policy we mean changes in structure, such as a change in the number of taxes". Tinbergen, ibid, P. 7.

2. Tinbergen ibid, P. 7-8.

overall effectiveness of monetary policy.[1]

It is apparent that such constraints are larger in number in an underdeveloped economy as compared with those in a developed economy. To the extent that 'institutional differences' are made an argument in the lesser effectiveness of monetary policy in the underdeveloped countries they should be made to refer to the additional constraints that affect the working of the policy rather than the nature of institutional arrangements as such, for differences in institutional arrangements do exist between developed countries also and they may not in substance, operate as constraints on the working of the policy instruments.

Tinbergen makes a still finer distinction when he speaks of the 'constrained value of a particular instrument'. Thus as he says "when income taxes are increased beyond a certain figure, evasion will assume larger proportions".[2] He terms this level of the value of the instrument as its 'boundary condition'. In regard to monetary policy we could say that the Bank Rate (not being varied by more than 2 to 3 percentage points at a time) or the 'reserve requirements' variations which take place with legally enforced limits are instruments operating with constrained values.

H.Theil would define constraints as 'those uncontrolled variables which are real-valued'. If with the passage of

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1. For instance Howard S. Ellis "Limitations of Monetary Policy" reprinted in 'Money National income and Stabilization Policy' (Eds. Smith and Teigen) Irwin (1965) Pp. 373-85.

2. Tinbergen ibid P. 25.

experience with a given policy design, it is found that the uncontrolled variable has ceased to be a constraint, then it enters into the instrument or goal functions. The constraints that we refer to are those behavioural conditions or institutional practices that set a limit to the effectiveness of monetary policy. Some of them which may be common to both the developed and undeveloped countries may be listed first as under :

(1) 'Velocity' of money: Income velocity of money has been referred to earlier as a powerful tool of analysis and a behavioural relation amenable to statistical measurement. If velocity shows peculiar numerical trend value[1] then it is not a constraint for policy. Similarly if it is an institutionally determined constant (which it is not, but was supposed to be an important part of the traditional Quantity theory argument) then also it does not operate as a constraint. But a variant of the opinion (a parallel of which is to be found in the earlier literature also) that velocity is a constraint on the operation of policy is echoed in the statement of the Radcliffe Committee to the effect that they could not find any reason for supposing that "there is any limit to the velocity of circulation", or when they say "all the hazeness of the connection between the supply of money and the level of total demand remains: the hazeness

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1. In a study done for India, it has been however, observed that over the years 1950-51 through 1962-63, "short-run changes in income velocity of money have either reinforced, attenuated or altogether counteracted the effect of changes in money supply on effective demand". (M.Saravane, "The behaviour of income velocity of money in India", Ph.D. Thesis (unpublished), University of Bombay (1969) P.213).

that lies in the impossibility of limiting the velocity of circulation".[1] If velocity is thus looked upon as a highly fluctuating and volatile phenomenon then it acts as a constraint on monetary policy. L.S. Ritter holds that velocity is not limitless and there is a ceiling on it though it is a flexible ceiling. But he is not inclined to accept the stability argument of the quantity theorists on the grounds that during 1948-62 there was an increase in velocity in the U.S.A. as against the secular decline established by the Friedman-Schwartz study. As he puts it 'the extraordinary empirical stability' that Quantity theorists find in the behaviour of velocity is revealed only to the disciples. But whether the Radcliffe Report is correct that for all practical purposes velocity has no upper limit whatsoever remains to be seen.[2]

Velocity has for long been treated as a constraint on monetary policy by the framers of policy. It would not, therefore, be out of place to quote the Board of Governors of the Federal Reserve system in this regard: "Experience shows that the rate of use or velocity of money varies significantly over short periods of time as well as over long periods". However they aptly add: "Variations in money turnover need not be considered as a bar to the effectiveness of monetary policy if policy formulation takes them into consideration although they may at times complicate its task".[3]

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1. Report of the Committee on the working of the monetary system P. 133 and P. 187.
2. L.S.Ritter "The role of money in Keynerian theory" in Banking and Monetary Studies - Dean Carson (Ed.) Irwin (1963) Pp. 134-50.
3. "The Federal Reserve and the Treasury: Answers to questions from the Commission on Money and credit". Prentice Hall (1963) Pp. 4-22.

(2) Trade Credit:- Credit extended by merchants and suppliers to the ultimate buyers in the form of a surcharge or loss of discount on delayed payment and such other variants of it which enable the ultimate buyer to refrain from resorting to bank borrowing (which he would have to do in the absence of the special facility) is often termed as Trade credit. When the monetary authorities aim at reduction in the private sector's expenditure through restrictive monetary policy, changes in 'net trade credit expansion' would act as potential frustrater of monetary policy. Although this influence of trade credit was hinted at by Mill, a plausible analytical exposition was provided by Lipsey and Brechling where they conclusively demonstrated that "net credit changes are a potential frustrator of monetary policy"[1]. As it is clear, a 'net trade credit' received by a firm serves as a substitute for bank money and higher the degree of substitutability between the two, greater the significance of trade credit as a constraint on monetary policy. The Radcliffe Committee making a reference to two studies by R.F. Henderson and J.A. Bates each yielding opposite results was inclined to consider the evidence as insufficient to "say how far trade credit took the place of bank credit during the credit squeeze"[2].

However in an important study conducted with U.S.A. data Arthur B. Laffer[3] has defined 'Unutilised trade credit

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1. "Trade Credit and Monetary policy" Economic Journal December, 1963.

2. Radcliffe Report - P. 106.

3. A.B.Laffer - "Trade Credit and the money market", Journal of political economy (March-April, 1970) - Pp. 239-267.

available' as 'the total additional capacity to acquire goods directly from sellers by incurring debt' and, therefore, analogous to bank credit. His findings are that in the U.S.A. "from 1946 through 1966 trade debt grew at an annual rate of 8.3 per cent whereas bank money grew at a rate of only 2.5 per cent per annum." The theoretical underpinning of his empirical testing is that "as interest rates rise (fall) the proportion of unutilized trade credit available to total money rises (falls) and that there is a very close substitution between bank money and trade credit money" with the further theoretical implication that "the supply of money, especially when unutilized trade credit available is included, is not purely exogenously determined". According to him, therefore, when interest rates rise "banks would want to reduce excess reserves and make additional loans at the greater margins .... firms would attempt to extend additional trade credit at higher rates".[1] Commenting on the policy implications he says "the implications of the close substitutability of trade credit for bank money are by no means harmless. If trade credit did not exist one would only need to know the relationship between effective reserves and both interest rates and demand deposits and currency to regulate the economy. One must (now) know in addition to the above mentioned relationships, the relationship between unutilised trade credit and both interest rates and bank money.'[2]

Put in terms of the point of view of the 'general liquidity' approach of the Radcliffe Committee 'net trade credit'

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1. Ibid P. 251

2. Ibid P. 257-58.

adds to the liquidity of the business units in general and may thwart monetary policy measures attempting to reduce liquidity.

According to the estimates made by the Reserve Bank of India, the relative use of 'borrowings from banks and trade dues and other liabilities' as sources of financing for the corporate sector were of the following order during the Second and Third Plan periods.

TABLE 3(1)

Source of financing of Public Limited Companies during Second and Third Plan periods.

(Percentage to total)

	Second Plan (1001 Companies)	Third Plan (1333 Companies)
External sources of financing (percentage to total) of which:	55.3	50.9
1. Borrowings from banks	16.4	18.8
2. Trade dues and other liabilities	15.1	14.9
3. Percentage ratio of 2 to 1	92%	79%

Source: "Reserve Bank of India Bulletin" December, 1967.

If we take the view that 'restrictive' monetary policy was followed with the beginning of the Third Plan, trade credit does not seem to have thwarted it on the ground that

its relative share as measured by its ratio to bank borrowings had rather declined from 92% to 79% over the Third Plan period. This was so however in view of an expanding banking system and the general accent on advances being diverted to industry relative to commerce (vide Chapter IV p.). These figures relate to use of trade credit by the corporate sector. The position in regard to small public limited companies and private limited companies however is that their relative reliance on trade credit is by far quite larger.

TABLE 3(2)

Relative reliance on bank borrowing and trade credit: All Private - Limited Companies

(Amount in crores of rupees)

	1955-56	1960-61	1962-63
1. Borrowings from banks	107	180	249
2. Trade dues and other liabilities	214	234	302
3. Percentage ratio of 2 to 1	200	130	121

Source: "Financial statistics of Joint Stock companies in India 1950-51 to 1962-63" Reserve Bank of India, Bombay (1967) P. 194.

If restrictive monetary policy takes the form of some selective measures of control those industries or sectors affected may meet the situation by getting net trade credit from other sectors of the economy. The significance of trade

credit as a constraint on monetary policy arises on account of three factors (a) as a potential frustrator (b) the implicit or explicit rate of interest[1] and (c) the adequacy or inadequacy of bank credit. Factors (a) and (b) have been referred to earlier. The last point (c) had been touched upon by the Radcliffe Committee and has relevance for the situation in India.

The Ministry of agriculture had estimated that in the U.K. total volume of trade credit extended by 'agricultural merchants and livestock dealers' was around £ 120 mln. (representing 4% of total short and medium term credit) and earned interest rates from 12 to 25 per cent. Although the Committee opined that "it seems unlikely that the cost of merchants' credit presents itself to a farmer's mind in terms of a rate of interest", it did agree that "merchants' credit is much more expensive than bank credit". The question, therefore, arises whether the preponderance of trade credit at rates higher than bank credit represents "fundamental gaps in the short term credit structure". Although the Radcliffe Committee was inclined to hold the view that it did not represent such a gap for the reason that to the farmer the convenience in having trade credit was more important than the comparative cost of trade credit and bank credit, the situation in India is different. Although no firm estimates about trade credit for the agricultural sector

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1. If cash discount is 2½% of the price and normal period of credit is one month, the rate of interest on trade credit works out to 30% per annum.

are available the money lender who combines in himself the role of a banker and a trader should be extending credit in his operations as a merchant at excessively high rates of interest. On the other hand "traders in villages obtain credit from the agriculturists postponing full settlement of the price till the end of the marketing season" with the result that "the wholesale trader can some times effectively meet the challenge of the credit squeeze by adjusting their trade credit position." It is likewise reported that "small units have often to extend more trade credit than they receive."[1] Bigger units in the corporate sector, in addition to their better liquidity position and stronger bargaining power, have the additional advantage of receiving through long tradition, public deposits at rather competitive rates of interest a part of which may be used to extend trade credit. It may be concluded that under Indian conditions trade credit does represent a gap in the credit structure let alone its relevance as a frustrator of monetary policy.

(3) Non-bank financial intermediaries:- Analogous to trade credit as a constraint on the effectiveness of monetary policy but more important in terms both of its magnitude and diversified forms is the wide range of liabilities of the Non-bank financial intermediaries[2] which work as effective substitute for bank money. The issue was highlighted in an important study on the financial system of the U.S.A. by

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1. Vide "Monthly Review" State Bank of India, Bombay, July 1968, P. 245-49.

2. to be referred to hereafter as NFI.

R. Goldsmith. The study revealed that over the years 1900-1952 share of commercial banks in the total financial assets had declined from 1/2 to 1/3 yielding place to other non-bank financial intermediaries. Aschheim has argued that the trend of relative decline of commercial banks has been reversed after 1952 and if we exclude those non-bank intermediaries which are under the control of the Government then the relative decline of commercial banks remains of the order of 52.8% (1900) to 44.8% (1952) as against the wider margin of 1/2 to 1/3 reported by Goldsmith.[1] The issue of the emergence of the NFIs was tackled at a higher theoretical plane by Gurley and Shaw who emphasised that "In some degree the debt they (non-bank financial intermediaries) create is a substitute for money. In some degree hence their expansion results in excess money.[2] Traditional monetary policy being framed with reference to controlling the activities of the commercial banks, emergence of NFIs would thwart the intentions of the authorities. Gurley and Shaw thus emphatically advocated extension of monetary controls over these non bank financial intermediaries. In looking upon the growth of NFIs as a constraint on traditional monetary policy, we do not intend either to underestimate or side-step the contribution that the Gurley - Shaw approach has made to monetary analysis. In particular the distinction that emerged from their approach, between 'outside money' (comprising of money created against Government liabilities)

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1. A. Aschheim - "Techniques of monetary control" - P.112-14.

2. Gurley & Shaw 'Reply to Culbertson'. American Economic Review (March 1958) P. 137.

and 'inside money' (money created against public liabilities) has helped put the wealth expenditure (influence of wealth on private spending) relationship on a more logical basis.

The implication of the Gurley-Shaw analysis for monetary policy has been that the NFIs by offering substitutes for money affect the demand for money. Their existence brings about a shift in the demand curve for money, so that money demand at the same rate of interest will be less than the amount demanded in the absence of the NFIs. Their presence thus increases the interest elasticity of demand for money implying thereby, as Patinkin had pointed out, to an improvement in the 'quality' of assets held in place of money.

Under restrictive monetary policy then the reduction in money supply necessary to achieve the desired degree of restriction will be greater when the NFIs exist than when they do not. Similarly, under expansionary monetary policy the increase in money supply required to bring about a given reduction in the rate of interest will be less with NFIs present than when they are not.

There is something common with both the Radcliffe Committee and the Gurley-Shaw approaches towards monetary control but the Radcliffe Committee though alluding to NFIs, as important alternative sources of liquidity did not favour imposition of any direct control over them. Milton Friedman's reaction to both these approaches is typical: "The emphasis

on money as an asset has led to emphasise on near moneys, as an alternative source of liquidity. One example is the work of Gurley and Shaw and their analysis of financial intermediaries as providing money substitutes. Another example in its most extreme form is in the Radcliffe Committee report which attempts to widen the concept of money to make it synonymous with the concept of liquidity, itself an undefined term, which covers the universe. My own view is that this particular trail toward widening the range of reference of the concept of money is a false trail. It will peter out and will not in fact be followed."[1]

Friedman's typical reaction to the whole set of ideas as a 'trail toward widening the range of reference of the concept of money' being there with whatever worth it has, the issue fundamentally is one about substitution between claims on banks and non-bank financial intermediaries. There are two ways of looking at this relation. One is to think in terms of the size of the market for claims. People have a tendency to keep some ratio of claims on NFIs, to claims on banks. If this ratio is constant then (say, with expansionary policy) claims on N.F.Is. will increase with an increase in claims on banks.[2] Then such a ratio could be included in the bank money multiplier as the currency deposit ratio is included.

D. Shelby[3] held that such a constant ratio exists.

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1. Milton Friedman in "Money and Finance", Deane Carson (Ed.) John Wiley (1966) P. 189.
2. D.A. Alhadeff 'Credit controls and financial intermediaries' American Economic Review, September, 1960 - P.661.
3. D.Shelby "Some implications of the growth of financial intermediaries" - Journal of Finance, Dec. 1958 - P.529-32.

The Alhadeff - Shelby conclusion does not entitle us to categorise NFIs as exercising any constraint on monetary policy. W.L. Smith[1] has however, argued that if any relationship exists it would be lagged one and is linked by income effects rather than balance sheet effect i.e. when bank deposits expand they alter total expenditure, income and savings and these in turn increase demand for claims on NFI. The time periods involved in the demands for both types of claims are different. What the degree of substitutability is and whether the process of substitution works with a lag then turn out to be empirical issues.

The relationship could be thought of in another way i.e. in terms of price (Interest) differential of claims on NFIs and banks.[2] If In is the overall rate of return on NFI claims and Ib on bank deposits then with perfect substitutability In-Ib = 0. The banks may alter the explicit rate of interest by varying service charges (an increase in them reduces the overall rate of return on bank deposits) but for all practical purposes we may assume that $In > Ib$. Then a widening of the differential will make claims on NFI more attractive and there will be a shift from bank deposits to claims on NFIs. The relationship then depends upon the degree of flexibility of interest rate variations with both in response to changes in monetary policy. The rates of return on claims on NFIs are generally more flexible than those on bank deposits (regulation

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1. W.L. Smith, "Financial intermediaries and monetary controls" - Quarterly Journal of Economics, November, 1959 Pp. 536-38.
2. J.A. Galbraith, "Monetary Policy and Non-bank financial intermediaries", in 'Macro-economic Readings' (Ed.John Lindauer); The Free Press (1968) Pp.324-29.

of interest on bank deposits being one of the contributory factors). So under restrictive monetary policy greater flexibility in returns on NFI claims will attract more funds towards them and away from banks and the NFIs. will work counter to the objective of the monetary authorities, because now the In-Ib differential will widen. With flow of funds from banks to NFIs the latter will expand while the former contract and hence effectiveness of policy is reduced. On the other hand, during expansionary monetary policy, when the differential narrows down "people once becoming customers of NFIs. may continue to remain customers even after the rate differential that attracted them to the NFIs. (narrows down or) disappears". The NFIs. thus behave in a manner to "affect monetary policy when bank deposits are contracted but remain neutral when bank deposits are expanded, (hence) monetary policy favours growth of NFIs. during tight money period a growth which is not lost during a period of easy money".[1] Those who think of the relationship between these two types of institutions in terms of their size accept the interest rate differential to be constant. But with different degrees of flexibility the outcome is to render monetary policy less effective.

This means that an appropriate interest rate structure is an important condition for effectiveness of monetary policy. We refer to this aspect of the matter in Chapter Eight.

The issue when seen in the context of an underdeveloped economy requires careful consideration. Fundamentally speaking the NFI would exercise a constraint on monetary policy in these

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1. J.A.Galbraith Ibid.

countries in the same manner as they do in the developed countries. By offering their liabilities at competitive rates of interest they might provide a check to expansion of commercial banking which is a part of the goal function of monetary authorities in these countries. It is out of such realisation that the Reserve Bank of India has instituted a series of controls on such intermediaries since 1966. The issue in underdeveloped countries cannot be settled merely by reference to a statistical measurement whether the liabilities of these intermediaries (and there is a special case of their classification too) are more or less close sbustitutes of bank deposits but how far in relation to the commercial banking sector their growth is conducive or inimical to the general objective of 'growth with stability'. Their growth alongside growth of organised banking has to become an essential part of the overall financial policy but on a priori reasoning it could be argued that if both types of financial intermediaries are expected to grow and if one (organised banking) is controlled, the other has to be kept under regulation. Such regulation has per force to take account of the price differential of claims on both categories of intermediaries.

CONSTRAINTS ON POLICY IN AN UNDERDEVELOPED ECONOMY:-

Our reference to velocity, trade credit and existence of NFIs. as constraints on monetary policy is to bring to the fore the need to make as explicit as possible these uncontrolled variables that are likely to affect the working of monetary policy to a smaller or larger extent depending upon the particular situation in a given country. Given that these constraints

are more or less effective in the underdeveloped countries there still remains a more formidable problem of tackling some additional constraints such as (i) the existence of a non-monetized sector (ii) dual money market (iii) currency component of total money supply and (iv) seasonality in bankimg operations. Cognizance of these factors has often led students on money and banking to declare that monetary policy has almost no positive role to play in an under-developed economy. It is essential that these constraints should be stated in a more explicit way.

(1) Non-monetized Sector:-

While it is difficult to estimate very precisely the extent of transactions carried out without the help of money, it has been estimated that about 60-82 per cent in Tropical Africa and a little over one third of the total income in India originates in the non-monetized sector. Basically a money economy thrives and survives when the spending units have a surplus to exchange, but the subsistence level of living in the rural areas and the tradition of making in-kind payments prevents the spread of a money economy. This sector remaining outside the pale of monetary policy, we have to enquire whether in analysing or computing the money income relationship we should not exclude that part of income which originates in the non-monetized sector. However with the spread of economic development there sets in a process of monetization of the non-monetized sector. The transformation of subsistence farming into surplus producing farming would basically determine the rate and magnitude

of monetization.[1] No doubt the non-monetized sector provides itself with a hedge against inflation, but keeping itself immune from more fundamental changes in the rest of the economy, it puts a ban on progress and becomes responsible for keeping the economy in the 'low level equilibrium trap'.[2]

It has been estimated that monetization in the Indian economy may be taking place at an annual rate of 1% per annum.[3] Thus granting that in 1950-51 the monetized sector was about 67% it may be about 77% in 1960-61 and about 82% in 1965-66. The arbitrariness involved in a 1% rise per annum computation has to be recognised.[4]

Monetary authorities relying on the 'monetary rule' criterion will have to form proper estimates about this

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1. Although a number of factors would determine this process of transformation, the transformation of a 'subsistence' into surplus farming would remain an important condition; but precisely because of that monetization may remain a discontinuous process, climate for instance, being one of the determinants of agricultural production.

2. C.P.Kindleberger (Economic Development (1958) p. 189) citing the example of Iran says that "when oil royalty and tax payments by the Anglo-Iranian Oil company to the Iranian Government ceased, it was feared that there would be collapse of the Iranian economy. But such a collapse went virtually unnoticed as the (small) modernised sector returned to the ways of its forbears and contamporaries in the subsistence economy."

3. Reserve Bank of India Bulletin July 1961 P. 1046.

4. "Liquidity in the Indian economy" Reserve Bank of India Bulletin November, 1963 P. 1402.

process of monetization to determine the appropriate level of money stock. Authorities relying on discretionary management may feel immune from the influence of the non-monetized sector but only in the short run and with important consequences to face in the long run.

(2) Dual money markets:-

Another limitation is to be found in the reflection of the dual character of an underdeveloped economy into its money market also. The Central Banking Enquiry Committee (1931) in India had estimated that the organised money market accounted for only 10% of the total financial transactions as against 90% being covered in the unorganised money market. The organised money market fed by and working on methods of modern banking remains amenable to monetary policy measures while the unorganised sector eludes them. Although more rapid extension of modern banking and relative decline in the unorganised sector has now reduced the relative proportion to 50:50 as against 10:90 in 1931, it does provide a limitation to efficient working of monetary policy. There are many aspects to be considered while dealing with the unorganised sector in the context of overall policy. Thus it has been argued that unorganised sector depends in no small measure on the organised sector and thus renders itself, susceptible to monetary control measures[1] or, it may legitimately be argued that we should accept the unorganised sector as a legacy of the past and take measure to fit them in a rational way into

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1. "Evolution of monetary policy in India" Reserve Bank of India Bulletin, April 1966 p.

the overall financial system rather than proceeding with ill-conceived measurs to suppress their activities without providing adequate alternative arrangements; this is basically then an issue in making the monetary system structurally efficient and to this we shall revert in Chapter 9. This however does not negate the general stand that existence of the organised sector per se is a limitation on the effective working of monetary policy.

(3) Currency component of total money supply:-

Still another important limitation so widely recognised and discussed is the very high proportion of currency in total money supply. Analogous to the position of the non-monetized sector in the total economy which by denying itself the advantages of a money using economy keeps low the level of real development, the position of currency in the total money supply indicates lower degree of financial accumulation. Preponderance of currency in total money supply on the one hand keeps the value of the money multiplier low; makes the credit structure less elastic and monetary policy less resilient. The season-bared pattern of production in agriculture on the other hand makes the problem more complex and itself becomes a cause for the currency predominant type of money supply. The commercial banks expand credit during the busy season (November to April) which brings about a general pressure on liquidity and enforces the commercial and co-operative banks to take recourse to borrowing from the Central Bank. While this seasonal pattern of banking operations brings the commercial banks more under the influence of

the Central Bank via their greater dependence on it, low spread of banking habits brings about a larger holding of currency with the public. Thus expansion of currency holdings with public during the busy season is not followed by return flow of currency to the banking system during the slack season (May to October). The ratio of currency to money supply has been a little higher in 1965-66 compared to what it was in 1951-52.

TABLE 3(3).

Ratio of currency to money supply

1951-52 to 1965-66

(Amount in Crores of Rupees)

Year (Last Friday of March)	Currency (1)	Money supply * (2)	Ratio of 1 to 2 (3)
1951-52	1286	1849	0.652
1952-53	1268	1804	0.702
1953-54	1289	1828	0.705
1954-55	1377	1955	0.704
1955-56	1571	2217	0.708
1956-57	1623	2342	0.692
1957-58	1674	2413	0.693
1958-59	1792	2526	0.709
1959-60	1931	2720	0.710
1960-61	2098	2869	0.731
1961-62	2201	3046	0.722
1962-63	2379	3310	0.719
1963-64	2606	3752	0.694
1964-65	2769	4080	0.679
1965-66	3034	4529	0.670

* Money Supply = Currency + Demand deposits.

Source: "Currency and Finance Reports" various years.

(4) Seasonality in banking operations :

It is sometimes claimed that on account of seasonal character of banking operations the reliance of the unorganised sector on the organised sector increases (particularly during the busy season) and this fact enhances the possibility of transmission of measures of monetary control to the unorganised sector. No data are possibly available to support such a contention but there is another aspect of seasonality which rather than being a constraint is supposed to serve in the capacity of an 'Indicator' with the monetary authorities. The Reserve Bank has normally followed the practice of announcing its 'busy season policy'. Deviations from it would then call for subsequent action on the part of the Bank. Between November, 1951 and March, 1966, the Bank varied the Bank Rate five times out of which on three occasions, the announcements were made during the busy season. Similarly if the commercial banks seem to be borrowing heavily during the slack season from the Reserve Bank such contra-seasonal trend would be looked upon with concern by the Bank and appropriate steps taken. During the period 1951-52 to 1965-66 excepting one year (1956-57) the net borrowings of commercial banks from the Reserve Bank of India have declined during the slack season. During the whole period again excepting the year 1956-57 commercial bank advances (loans and bills discounted) also declined during

the slack period and increased during the busy season. A contra-seasonal movement of bank credit (expansion during the slack season) would similarly cause concern with the Central Bank. It may be noted that much of the expansion in commercial bank credit during the busy season takes place to finance movement of harvested produce directly (though in a smaller measure in view of the small contribution of commercial bank credit to agriculture less than 2.4 per cent in 1965-66) but more importantly to meet with financial requirements of industries (Such as Cotton and Jute textiles, Vanaspati etc.) which depend on agriculture for their raw materials. With the emergence of a diversified industrial structure comprising of chemical and metal-based industries the seasonal character of the credit structure is likely to yield place to a mere unified and coherent pattern.

GOALS OF MONETARY POLICY.

Hicks' assertion that monetary theory is historically conditioned[1] may be even more relevant for monetary policy. It was perhaps out of such consideration that K.N.Raj[2] was led to believe that "there was never a theory of Central banking, except in the eyes of those who mistook certain traditions for theory".

Both in regard to the variety and sophistication in nature of instruments as well as in regard to goals, monetary

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1. J.R.Hicks....."Critical essays in Monetary Theory" P.156.
2. Quoted in C.R.Whittlesey "Lectures on Monetary Management" Vora & Co., Bombay (1960) P. 6.

policy has lived through a long process of experimentation and evolution. Till the days of the gold standard, monetary policy was supposed to do some sort of 'fine tuning' by varying money supply or interest rates, in maintaining harmony between 'external' and 'internal' equilibrium. But with the eclipse of the gold standard mechanism during the first war and for some years thereafter; the growing concern with domestic stability, made necessary by the imbalances and rigidities of the war-torn economies, and the emphasis placed by both the Macmillan Committee in England and the World Monetary Conference at Brussels on price stability, the number of goals that a Central Bank was legitimately expected to serve increased. The impact of Keynes' General Theory on monetary policy was on the one hand to play down its role but on the other hand to add one more variable 'attainment of full employment' - into its goal function, the 'Growth' objective being still another addition in the post-Keynesian era. The Radcliffe Committee had as such given a 'complex of objectives' as under:-

(i) A high and stable level of employment.

(ii) Reasonable stability of the internal purchasing power of money.

(iii) Steady economic growth and improvement of the standards of living.

(iv) Some contribution, implying a margin in the balance of payments, to the economic development of the outside the world.

(v) A strengthening of London's international reserves, implying further margin in the balance of payments.

The committee had tried to "acknowledge that there are serious possibilities of conflict between them" but also had added that the "choice between conflicting alternatives is a continuous process to be lived through all the time".[1] The Commission on Money and Credit in U.S.A. on the other hand preferred to keep the list of objectives confined to: (1) adequate economic growth (2) low levels of unemployment and (3) reasonable price stability which relate more to the working of the domestic economy.[2] Having recognised that "the possibility of conflict among the goals" is "a very real one", and having examined the area of conflict and possibilities of compatibility, the Commission was inclined to conclude that the "three goals can be achieved simultaneously, and that they are fundamentally compatible".[3] A more rational approach towards the interrelationship among goals should be to explore and assess quantitatively "the costs and benefits of alternative compromises between conflicting policy objectives", as we shall see hereafter.

EFFICIENCY IN MONETARY MANAGEMENT

Normal efficiency solution for a policy in terms of the instruments/targets relationship as given by Tinbergen is that

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1. Report of the "Committee on the working of the monetary system"; London (1959) P. 20-23.

2. "Money and credit, their influence on jobs, prices and growth", Prentice Hall (1961) - P. 12.

3. Ibid.

the number of goals should be equal to the number of instruments. Incidentally it may be noted that the Friedman type monetary policy seeking to meet the demand for money of a growing economy with stable prices (goal) through a given monetary rule (instrument) yields an efficient policy solution, on this reckoning.

R.A.Mundell has advanced another criterion for efficient policy solution. On the Tinbergen criterion it would be necessary to have two instruments (Monetary policy and Fiscal Policy), if two goals (full employment and external equilibrium) are to be achieved. Each instrument could be used independently for either goal but Mundell has shown that there is gain in pairing both the instruments on the basis of comparative advantage.[1] Thus to meet the full employment goal 'easy budget' (budget deficits) policy alone may serve the purpose but it would adversely affect the current account of the balance of payments, but if 'easy budget' is paired with 'tight money' this would raise interest rates, attract foreign funds and counter the adverse effect of easy budget on current account through favourable effect on the capital account.

Conversely pairing of "easy" money with "tight (surplus) budgets" would not yield an efficient solution for while easy money might achieve the full employment, goal effect of 'tight budget' on balance of payments will be uncertain.

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1. "The Appropriate use of Monetary and Fiscal Policy for internal and external stability", I.M.F. Staff Papers - (March, 1962) Pp. 70-79.

Pairing has thus to be done on basis of comparative advantage. This approach augurs well for a policy-mix strategy and the conclusions could be subjected to empirical verification also.

H.G.Johnson tackling the problem from a much wider angle has well observed that "economists concerned with monetary management have been decreasingly concerned with institutional and historical questions per se and increasingly concerned with institutional and normative problems i.e. problems of efficiency in monetary management. This approach requires the application of economic theory - and in some cases of econometrics - more intensively to the processes and practices of monetary management than has generally been done in the past".[1] Accordingly he emphasises three aspects of the problem of efficiency:

(a) structural efficiency

(b) efficiency in stabilization policy

(c) efficiency in secular economic policy.

The first aspect (a) relates to maintaining efficiency of the banking system 'considered as an industry' in terms of its dual role of providing a payments mechanism as well as that of playing "an important part in the capital market as a medium for saving and allocation of capital among competing borrowers". The other two (b) and (c) relate to conduct of monetary policy in terms of the 'standard four' of goals;

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1. H.G. Johnson "Problems of efficiency in monetary management" Journal of political economy (September - October 1968) Pp. 971-90.

full employment; growth; price stability and external equilibrium. In accomplishing these goals monetary policy would need support from other policy measures.

'Short run' and 'Long run' aspects of monetary policy:-

Discussion in current literature often runs in terms of whether monetary policy is a potent measure of control for short run stabilization purposes or for long run growth of the economy. Granting that "the long run relationship between the supply of money and the level of national income will be more stable than the short", R.J.Ball[1] suggests that "the burden of short period adjustment may be imposed on fiscal rather than monetary policy". Although short period countercyclical or stabilization policy means achievement of full employment and price stability goals in the short run 'stabilization' policy in itself is now being looked upon in a much wider context than before. As Carl S. Shoup[2] puts it "although the term 'stabilization' suggests a static economy the problem in practice is one of assuring

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1. i) R.J.Ball: "Inflation and the theory of money" (1963) P. 282-83.

   ii) Friedman considers that use of fiscal measure as short run stabilization policy in preference to monetary policy would be to produce a more destabilising effect than what monetary policy would do for fiscal changes have less of reversibility and flexibility compared to monetary changes.

2. C. S. Shoup: 'Public Finance' Weidenfeld and Nicolson (1969) P. 539.

employment to a growing force and utilization of an increasing stock of capital goods". Nevertheless Shoup hastens to make a distinction between the goals of full employment and economic growth on the ground that "full employment simply implies full utilization of whatever resources are available at the time, regardless of the disposition of the output between capital goods and consumer goods while Growth Policy determines what proportion of the total full employment output shall be devoted to capital formation in the broadest sense". The issue has been put more cogently by Johnson pointing out that stabilization policy involves taking actions necessary to correct 'spontaneous destabilizing developments in the economic system'. He would agree with Shoup[1] and Culbertson[2] that traditionally theories regarding stabilization policy are couched in terms of static analysis while "stabilization problem requires the use of policy instruments which operate with a varying (distributed) time lag on an economic system that responds to both spontaneous and policy-induced changes according to its own distributed lag pattern.[3] Since knowledge of those in charge of policy formulation about the distributed lag structure is not sufficient, we have to bear with deviations of policy measures

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1. Cited above.

2. Cultertson's main complaint against traditional stabilization policy is that it does not take into account the 'feed-back' effects. Monetary Policy to be effective must take into account the positive or negative monetary feedback. Vide his "Macroeconomic theory and stabilization policy". Mc-Graw Hill (1968) Chapters 18-19.

3. Johnson Ibid (J. of P.E.) P. 981.

from their desired performance. It may well be argued that short run stabilization measures "might do more harm than good" when (apart from the lag in effect of monetary policy) monetary policy measures disturb the public expectations based on past experience and this may cause more distortions in private economic calculations. So as - Johnson puts it "the disturbances resulting from unintended or anticipated effects of monetary policy actions might outweigh the intended beneficial effects".[1] The general implication of stabilization policy however has been and remains that it helps better allocations of saving and investment among alternative uses. The recent discussion on the desirability and choice of Indicators in monetary policy formulation is part way in solution of narrowing down the discrepancy between actual and desired performance of the policy measures. The controversy between the 'Money stock' indicator and 'interest rate' indicator groups has not however been settled, as seen earlier in chapter two.

Monetary Policy goals and their interrelationship:-

We may now state that the whole gamut of monetary measures (sometimes in combination with other measures) should seek to achieve the objectives of:

i) Keeping the banking system in a state of 'Structural Efficiency'.

ii) Minimising deviations, of the economic system from its 'desired trend path of evolution'[2] (stabilization policy aspect).

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1. H.G.Johnson "Essays in Monetary Economics" P. 216.

2. The term is due to H.G. Johnson (J. of P.E. 1968) op. cit.

iii) Selecting the 'desired trend path of evolution' itself (secular policy aspect).

Put otherwise, we have to see how far monetary policy can succeed in achieving the goals of (a) low levels of unemployment (b) Price stability and (c) Economic growth (the C.M.C. classification) and further to examine whether they are compatible and if not what are the issues involved when a compromise has to be made among these objectives. The first objective (a) above would necessarily be a matter of concern with a developed economy[1] while the other two objectives would equally concern both the developed and underdeveloped economies. We may however, hasten to add that achievement of objectives of Growth and Price Stability would be incomplete (and there may be impediments to their achievement also) without achievement of a 'structurally efficient banking and financial system'.

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1. The problem of unemployment in an underdeveloped economy first made explicit by Nurkse in his famous concept of 'Disguised unemployment' (and the 'saving potential flowing therefrom') has been a source of controversy leading to such issues as (i) measurement of disguised unemployment (ii) adoption of labour-intensive versus capital-intensive types of production programmes and (iii) (in general terms) the strategy of Planning itself. Open unemployment, particularly of the 'educated' as in India has added another dimension to the problem. The problem of disguised unemployment and, therefore, of surplus labour and in particular the issue of its measurement has been a source of extended controversy. While the general stand of most of the Indian economists has been to accept existence of surplus labour as a valid assumption, T.W. Schultz has doubted (and advanced an empirical test in support of his argument) the existence of any such labour (Refer J. Bhagwati and S. Chakravarty "Contributions to Indian economic analysis, A survey". Americal Economic Review, September, 1969 (Part II) Pp. 54-60).

The report of the Commission on Money and Credit[1] carries out in almost a formal and much less vigorous manner the problem of interrelationship among the three objectives[2] and finds that there is no conflict between the objectives of low levels of unemployment and growth although the relationship between low levels of unemployment and price stability and that between growth and price stability may need some compromise but virtually not much significant so that all the three goals may be said to be compatible, "if we do not expect the impossible for each" (the underlined statement is of the Commission but it has not been elaborated and may, therefore, be treated as of no significance). We may, therefore, briefly deal with the problem of relationship between the twin objectives of low levels of unemployment and price stability and take up discussion of the relationship between growth and price stability in relation to an underdeveloped economy with appropriate reference to its bearing for a developed economy.

The problem of external balance:-[3]

The Commission on Money and Credit rejected consideration of this as a goal of monetary policy on the ground that "the costs in terms of unemployment and lower growth would

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1. Report of the Commission on Money and Credit : P.45.

2. The objective of 'Structural efficiency' will be dealt with while discussing the policy objectives in regard to underdeveloped countries. (Pp.)

3. We abstract from consideration of joint use of monetary and fiscal policy underlying the Mundell criterion referred to earlier.

be so great from trying to correct our balance of payments deficit by general monetary and fiscal policies that alternative measures should be sought to achieve the necessary balance".[1]

The Radcliffe Committee on the other hand having enlisted "a strengthening of London's international reserves, implying further margin in the balance of payments" possibly made external balance coterminus with that 'further margin' and thus alluding to use of interest rate policy for this objective.

W.T. Newlyn[2] seeks a definitional compromise by condensing two objectives into one - "maintenance of external equilibrium at full employment" - but this evades the issue of conflict between the two objectives rather than solve it. We have, however, not touched upon the objective of external balance here on two grounds: First, there is some justification in J.S.G.Wilson's[3] view that preoccupation of monetary authorities

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1. Report of the Commission on Money and Credit. P. 227.

2. "Theory of Money", Oxford (1962) P.148.

3. "Monetary Policy and the development of money markets" George Allen & Unwin (1966) P.70.

   Wilson of course does not provide any theoretical solution to the complex problem of 'external balance' and 'domestic' objectives of monetary policy and only provides some relief to the policy maker in his decision making. T. Scitovsky has tried to extend the portfolio balance approach to balance of payments analysis and has emphasised the 'relative difficulty' of asset adjustments internationally as compared with the case of intra-national asset adjustment - another constraint on the slow international adjustment being reluctance of the Governments to allow automatic market forces to operate. (T. Scitovsky : "Money and Balance of payments (1969)"and Review article by H.G. Johnson - Journal of political economy,March-April 1970 - P.424).

with external balance may divert their attention from problems of domestic economy as such. Commenting on the situation in Britain he said "the very fact that the margin (in the balance of payments) has been so slim has kept the authorities in Britain on their toes. I believe that people in this country worry too much about the level of reserves. It is the state of the economy we ought to worry about".'

Secondly the balance of payments problem in an under-developed economy being subject to controls (on trade and exchange) and variegated influence (foreign aid, debt burden etc.) from many sources is rendered more complex and is not therefore easily amenable to monetary management.

THE TRADE-OFF BETWEEN LOW LEVELS OF UNEMPLOYMENT AND PRICE STABILITY.

The implication of 'General theory' was to emphasise full employment and disregard inflation since prices were more or less treated as an institutional datum.[1] However it soon became clear that the main problem for a free enterprise economy was not how to achieve full employment but how to maintain it, if prices continue rising in the wake of a full employment condition. As a solution it was suggested that maintenance of full employment might necessitate some institutional reforms to strengthen forces of competition, removal of rigidities and imbalances and thus making the

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1. The interpretation is general. Use of the term is due to Milton Friedman (Journal of Political Economy - March-April, 1970) P. 216

system, in general, more competitive. At another level the issue however emerged in the form of controversy over the cause of inflation, and various concepts of inflation - emerged.[1] But a more interesting result of these efforts was the hypothesization of the relationship between rates of unemployment and rates of changes in wages (and therefore in prices in general) in the form of the famous Phillips Curve. This approach did not find it necessary to squibble over the cause(s) of inflation. Basing his approach on data of rate of unemployment and rate of change of money wage rates in the United Kingdom during the period 1862-1957, A.W. Phillips found that both were inversely related, the relationship yielding a normal downward sloping curve (curvilinear relation).[2] The Phillips curve implicity grants changes in money wage rates in excess of wage increase that could be absorbed by increased productivity (keeping prices stable) and thus it is possible to derive the relation between 'unemployment' and 'price change' with due reference to 'productivity change'. Phillips had estimated that it is possible to determine the level of unemployment necessary to achieve price stability at about 2½ per cent for the U.K. and 7 to 8 per cent for the United States.[3]

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1. As one text book writer (A. L. Mayers: Modern Economics) put it "there are as many definitions of inflation as there are people who use the term". The types of inflation that have received wider attention were (i) Demand-pull (ii) Cost-push and (iii) Sectoral demand Shift (due to C.L.Schultz).

2. The curvilinear relationship implied that rate of inflation increases more than proportionately as the percentage rate of unemployment falls and decreases less than proportionately as the percentage rate of unemployment increases

3. A.W. Phillips, 'Employment, inflation and growth', Economica, February, 1962 - Pp. 1-17.

A study by Samuelson and Solow[1] showed that U.S. data based on an annual time series for the period 1946-58 revealed the trade-off of the following order:

Cost of Price stability (zero rate of price change) = 5 to 6 per cent rate of unemployment.

Cost of full employment (3 per cent unemployment level) = 4 to 5 per cent rate of inflation.

Klein and Bodkin[2] reported the trade-off between price stability and unemployment to be of the order of 6 to 9 per cent rate of unemployment. Their findings have made the trade-off more severe than the Samuelson- Solow results.

The Phillips curve thus demonstrates that there is a dilemma for the policy maker in the form of a compromise between low levels of unemployment and price level stability. On plain reading the shape of the curve suggests that a shifting in of it towards the origin implying less unemployment for the same rate of inflation or less inflation for the same rate of unemployment would increase welfare (to have a 'healthy Phillips curve' as Samuelson[3] would like to put it). The impact of the Phillips curve at the policy level has been the search for a more broad based policy termed

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1. P.A. Samuelson and R.M. Solow "Analytical aspects of anti-inflation policy", American Economic Review May, 1960.

2. "Inflation, growth and employment" (C.M.C. Study) Prentice Hall (1964) P. 393.

3. P.A. Samuelson in 'Monetary process and policy' G. Horwich (Ed.) Irwin (1967) P. 11.

as 'Incomes policy' employing monetary and fiscal measures including a wage freeze programme. Britain's experience with this policy has not been very encouraging however.[1]

At the theoretical level the logic of the Phillips curve has been called in question. The curve postulates that 'inflation' can be traded off (bargained) with 'unemployment' and since the ideal choice of the society would be to have zero rate of unemployment with zero rate of inflation the point of origin of the axes would be the ideal for the policy maker. Since however a point has to be chosen on the curve (with possibility of its shifting) the society (policy makers) may, given its collective utility function, choose an optimal position on the curve. But the process of choice (and the attainable optimal position) is a difficult one for as Johnson puts it 'unlike the nuts and apples of conventional preference theory, these are not strictly comparable comparable objectives of choice'.[2] The process of choice may be determined however by measuring the relative social costs of both inflation and unemployment.

The argument may be stated in terms of the relative benefits of price stability, and full employment but in this

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1. A Steering Group to provide guidelines for a 'framework for incomes and prices policy' constituted by the Reserve Bank of India in June 1964 reported in a very general and tentative way about the need and machinery for evolving such a policy in India (Refer: "Report on a framework for Incomes and Prices Policy" - Reserve Bank of India - 1967).

2. H. G. Johnson Ibid (J. of P.E. 1968).

case the advantage of depicting the choice diagrammatically as in the Phillips curve will be lost.

The social cost of unemployment may be measured by the potential loss of output. However, as Johnson[1] has pointed out several other considerations would enter the calculation of loss of potential output. If older people retire on account of their preference for unpaid to paid activities, if employed persons prefer to work less hours in order to have self-education or if idle time is utilised for search of better employment, these values or benefits of unemployment will have to be reckoned and deducted from the calculations of social costs of loss of potential output. Put otherwise the costs of unemployment in order to keep the economy at a particular rate of inflation will be lower with the inclusion of the above benefits than without them.

The social costs of inflation (associated with each rate of unemployment on the Phillips curve) mainly arise from (i) redistribution of resources from "those holders of assets whose value is fixed in terms of money to those, whose liabilities are fixed in terms of money" and (ii) waste of real resources when people in their efforts to evade the inflationary tax (inflation being a tax on the real money balances) reduce their real holdings of money by holding inventories of goods instead of cash. Again by shortening the payment periods, inflation may "divert a great deal of the effort of private business into forecasting or hedging against the uncertainties involved" and thus entail waste of real resources.

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1. H.G. Johnson, Ibid.

In so far as the redistribution effect is concerned the cost of inflation could be measured in terms of whether the new state of distribution is desirable or not. A more important consideration in measuring the cost of inflation is whether it is expected or proceeds in an erratic manner. Suppose the monetary authorities desire to incur no costs of inflation, then they will have to choose the rate of unemployment given by the point where the Phillips curve crosses the X-axis. This may be called the 'natural' (natural in the sense of its being consistent with price stability) rate of unemployment.

Friedman has argued that the Phillips Curve is given 'independently of the expected rate of inflation. The relationship however could not be depicted without reference to expectations. "Since it is concerned with long time price movements, with great variability in them, it implicitly incorporates average expectations about prospective price movements."[1]

If people expect the rate of inflation they will make efforts to so design their bargains that their monetary returns now include compensation for the fall in the value of money. In this case there will be no redistribution effects. Now suppose the monetary authorities try to maintain a rate of unemployment lower than natural rate of

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1. Milton Friedman 'The role of Monetary Policy', American Economic Review, March, 1968 - Pp. 1-17.

unemployment. The chosen point being away from the Natural point and towards the origin there will be a rate of inflation given by a point on the Phillips Curve corresponding to the chosen point (rate) of unemployment. If people expect this rate of inflation they will incorporate it into their bargains so as to achieve a state of zero price change but this will shift the Phillips Curve continually upward - "obliging the monetary authorities to increase the money supply at an ever accelerating rate". If on the other hand the monetary authorities choose a given rate of inflation and, therefore, the rate of unemployment corresponding to it on the X-axis, that rate of inflation will be built into their expectations and 'unemployment will gradually rise to the rate initially consistent with price stability'. Thus as Friedman puts it, "there is always a temporary trade-off between inflation and unemployment; there is no permanent trade off".[1] The issue is well made explicit by Johnson[2] when he says "there is either a long run trade-off of less unemployment for more rapid points of accelerating inflation, or a long run trade-off of less unemployment now for more inflation later." To the extent that the choice becomes one of less unemployment in the current period at the expense of greater costs of inflation in the distant future, the real policy issue boils down to the question of having an optimal rate of inflation or deflation (it being assumed that social rate of time preference is zero).

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1. M. Friedman, (A.E.R.) Ibid.
2. H. G. Johnson (J. of P.E. 1968) Ibid.

GOALS OF MONETARY POLICY IN UNDERDEVELOPED COUNTRIES

Turning over attention to the underdeveloped countries the 'standard four' of 'full employment', 'Growth', 'Price stability' and 'External stability' objectives will have to be recast as the basic objective of promotion of economic growth. Choice of economic growth as the objective (in a blatant way as we did here) would however place monetary policy in a dubious position. For one thing such determinants of economic growth as originating in technological changes, innovations, skill formation and so on are matters outside the pale of monetary policy. Monetary policy would doubtless help growth by promoting savings and channeling them into investment.[1]

The growth objective in our discussion regarding the developed countries merged with that of avoidance of unemployment.[2] Our discussion regarding the underdeveloped economy has to proceed in terms of two related questions (i) how far will the growth objective serve the employment

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1. Growth models have generally abstracted from money. Recent efforts by Johnson and Tobin to incorporate money in growth models have enriched our knowledge about the way money influences growth but no reliable guide for monetary policy has yet emerged from this technical analysis.

2. Since the basic issue in policy formulation is some trade-off, we could easily deal with trade-off between rates of unemployment and inflation but growth is not a magnitude but a rate of change of magnitude and hence not comparable with the earlier two magnitudes (stated as rates). Further for a developed economy the state of employment may be taken as a proxy for growth.

creation objective and (ii) what price level path will it follow. In addition to this basic objective as related to its two aspects (employment aspect and price level aspect) mentioned above, we may add another objective concerning structural and institutional aspects (in so far as they relate directly to money and finance) of the growth objective. As L. V. Chandler puts it: "Nations still value what was once the primary objective of a Central Bank - protection of the integrity of the nation's money. Yet the relative power of the objective has been downgraded as other objectives have come to weigh more heavily. The most obvious of these is the desire to achieve a higher rate of economic growth. But this is by no means the only purpose that Central banks are expected to serve. In country after country, the Central Bank is also expected:-

(1) to maintain a continuously low structure of interest rates, in some cases at levels comparable to, or even below, those prevailing in countries that are most richly endowed with capital;

(2) to assure the success of government financing at low interest rates, no matter how large or small the Government's deficits may be or how wise or unwise its fiscal-policy;

(3) to force the community to save a larger fraction of its real income - this despite an unwillingness to use the governments' tax power to this end;

(4) to create a broad and continuous market for government securities;

(5) to extend and develop the system of financial institutions and

(6) to provide credit, often at preferentially low rates, for favoured borrowers in the private sector.

....an imposing list of objectives to be promoted simultaneously by monetary policy."[1] Chandler has hinted at the constraint on monetary policy ((2) above) which P. R. Brahmananda has rightly termed as the behaviour of 'recaltritant fiscal authorities'.[2] In our discussion on the objectives we have, therefore, to assume that the 'fiscal environment' is not detrimental (if not conducive) to the effective operation of monetary policy. Objectives at (4) and (5) above relate in effect to the objective of maintaining 'structural efficiency' as we would broadly conceive it. The objectives may now be put as:

(A) Economic Growth in relation to its two aspects of employment and price level path

(B) Structural efficiency of the banking (financial) system.

(A) has been widely discussed in economic literature and (B) has received treatment hitherto either in a suggestive way or in terms of practical solutions. As pointed out earlier we consider the 'structural efficiency' objective as an essential compendium of the growth objective and,

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1. L. V. Chandler, Central Banking and Economic Development (1962). University of Bombay - P. 18-19.

2. P.R. Brahmananda in "Monetary Policy and Central Banking in India", V.R.M. Desai (Ed.) Popular Prakashan, Bombay (1969) P. 40.

therefore, propose to add it to the goal function of monetary authorities in underdeveloped countries.

(i) The growth objective in relation to employment aspect:-

The extent to which the growth objective will simultaneously serve the employment objective depends upon the growth strategy followed in a particular country. The choice between 'Balanced' and 'Unbalanced' types of growth models or the choice of teachinque, whether it is capital-intensive or labour-intensive will be of relevance here. But these matters will be important in specifying the degree of the employment creation effect which would differ with each one of the choices and the general conclusion may, therefore, be advanced that achievement of growth objective will per se fulfil the employment creation objective also. To the extent that 'small' industries are labour - intensive (to say rather employment - creating) which unfortunately is an unsettled issue and monetary policy is designed to provide finance at concessionary interest rates or on priority basis to them the employment creation objective is served with the proviso however that overall growth rate is not reduced or remains what it would be in the absence of such designing of policy.

(ii) Growth objective in relation to price level path:-

Economic growth may be associated with rising, falling or stable price levels during different periods of time. Economists favouring growth with falling price level path

remained in minority. Although their argument about falling price level, in a growing economy, ensuring distribution of its 'fruits of progress' to the widest section of society remained valid, the general fear about such a price level of creating deflationary tendencies has carried greater weight.

It is interesting to note the observations made by P. R. Brahmananda in this regard in relation to underdeveloped countries: "A gently falling price level path will help to raise the ratio of monetised income to total income, create a demand for money as a store of value, reduced the propensity to hold gold and goods, redistribute real purchasing power in the hands of the poorer strata, possibly raise the ratio of savings to income and cause an improvement in the 'quality' of labour through the impetus it provides to the education and training of the middle and lower income classes, expand the area of operation of financial intermediaries, prevent the propensity to borrow unproductively ... But it is perhaps more difficult to attain the above goal in an underdeveloped economy than it is in a developed economy."[1]

The above reasoning conducted on an abstract plane is valid and points to a 'tearless' growth process as one may wish to put it. Once however we grant that an underdeveloped economy operates with a planned programme of resource mobilization for accelerating the pace of development it has

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1. P. R. Brahmananda - Indian Economic Journal April-June, 1970. P. 593.

to be conceded that the growth process may be accompanied by either zero, mild or high rate of inflation.

There is neither a theoretical framework nor empirical evidence to establish that maximal growth rate has been accompanied by a particular rate of price change. High and low growth rates have been consistent with negative zero or positive price change. As the Commission on Money and credit has put it "the evidence covering a wide range of periods and many countries shows that with price increase from zero to 6 per cent per year, there is no appreciable association between the rate of growth and the rate of price changes. As a broad generality, countries with decreasing prices or with rates of price increases greater than 6 per cent appear to have lower growth rates than those operating within these limits".[1]

A zero rate of price change just may not materialise for an underdeveloped economy because there would be at least some 'functional price rise' to bring forth mobility

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1. Report of the C. M. C. (1961) P. 44.

of resources.[1] This again does not mean that a period of falling prices will be accompanied by declining growth. The outstanding example for India has been the behaviour of the general price index during the First Plan (1951-56) which showed a fall of 17.2 percentage points (1950-51 = 100) while net national income increased by 18.52 percentage points (1950-51 = 100) during the same period money supply (defined as currency plus demand deposits) rose by 10 percent while money supply inclusive of time deposits rose by 14 percent so that there was no contractionery effect emanating from the money supply side during the period. The Second and Third five year Plans witnessed

- both rising

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1. (i) Such a view was earlier advanced by the Bernstein Fund Mission for India. See "Development with stability" Government of India (1954) P. 6.

It is maintained that development would entail rising prices in the expanding (priority) sectors but the price fall in the sagging sector may not fully compensate the rise in prices in the former sector with the result that there may be an overall price rise.

(ii) In a similar vein it has been argued by G. Maynard ("Economic Development and the price level", Macmillan (1963) P.6) that the absence (rather relative low growth) of financial intermediaries creates the structural problem of transferring purchasing power from the surplus units to the deficit spending units. The government through money creation and inflation may short-circuit this transfer procedure and help economic development. We shall however, argue that this is neither a reasonable assumption nor a rational policy measure. To the extent inflationary process delays or obstructs the growth of the financial structure it remains inimical rather than beneficial, to the development objective.

prices and rising national income (annual variations apart, and the year 1965-66 experiencing a fall in national income in the face of a rising price level).

There is as such no systematic relationship between rate of inflation and rate of economic growth although a general proposition can be advanced that a mild type of inflation rather than zero rate of price change or falling prices by helping effective mobilization of resources may foster economic growth.

The issue of growth in the context of a mild type of inflation has been extensively discussed in economic literature and has been a matter of concern with the Reserve Bank of India since the beginning of the Second Five Year Plan. The theoretical framework showing how rising prices will promote development can be stated in terms of both Keynesian and Quantity theory analyses. The Keynesian approach lays emphasis on the 'redistributive -effect' leading to 'growth effect' in the manner that inflation transfers purchasing power from the group of fixed income receivers (peasants and workers) towards the group of variable income receivers (the entreprenurial class) and the propensity to save of the latter group being higher than that of the former brings about an increase in the total volume of savings. This argument depends upon two crucial assumptions namely that the latter group invest their inflation-induced incremental savings in

productive channels and the former group provides savings forced upon it by rising prices. The analysis thus assumes that there is wage rigidity or if wages begin to rise they lag behind prices. However the condition of continued inflation would enable the fixed income receivers to anticipate it and thus press for upward revision in their rewards. So will be the case with market rates of interest when holders of fixed interest bearing assets will try to compensate themselves and raise the market rates of interest. The 'redistribution effect' approach of inflation was at the basis of Hamilton's[1] study of the beneficial effects of inflow of gold in the Spanish inflation though Kessel and Alchian have shown that Hamilton's statistical test was biased and that no wage price lag could be detected in the Spanish case.[2] W. A. Lewis had also rested his case for inflation-induced development programmes on similar reasoning.

The Quantity theory approach on the other hand would straightway regard inflation as a tax on real money holdings of individuals. Given a stable demand function for money, individuals will hold their real cash balances (M) in a

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1. E. J. Hamilton - American Treasure and the Price Revolution in Spain 1501 - 1650 (1934).

2. Kessel and Alchian 'The Meaning and validity of the Inflation-induced lag of wages behind prices' - American Economic Review, March, 1960.

given proportion to real income (Y). With stable prices their demand for money M/Y will not change but when inflation occurs the cost of holding real balances increases so they will be induced to reduce the quantity of money demanded in order to maintain their real cash balances intact. But in their efforts to maintain their real cash balances intact the holders of cash balances loose real resources and this loss constitutes a 'tax' on holders of cash balances. However the resources collected by the inflationary tax when utilised for productive investments will help economic growth. Thus under the Keynesian approach there is a group-based redistribution effect releasing resources (real savings) and so under the Quantity theory approach also there is a redistribution effect but of a different type. Here the holders of money balances loose in favour of the issuers of money balances (i.e. monetary authorities). Under both the approaches the effectiveness of inflationary policy (for promoting growth) would depend upon the expectation about inflation so that individuals both as fixed income receivers and holders of money balances will try to adjust their contracts with due regard to loss arising out of inflation and there will be no transfer of resources. Even granting that inflationary policy under either approach succeeds in mobilizing real savings, some offsetting influences need also be taken into account. The resources flowing to the hands of the entreprenurial class (Keynesian approach) need be invested in productive channels

and not be wasted in holding inventories for speculative purposes or flow into real estates, holdings of gold, jewellery or foreign exchange. On the other hand while the inflationary tax releases resources holders of cash balances in their efforts to evade the tax-to save themselves from being compelled to release resources may try to shorten the payments period, substitute cash for inventories of goods and thus bring about waste of real resources.[1] It then follows that monetary authorities trying to pursue the objective of growth with mild type of inflation will be confronted with a choice to trade the resource-mobilizing benefits[2] off for the costs entailed in the redistributive and the waste of resources effects. This trade-off problem has thus led some economists to consider whether there could be any rate of inflation which may be called 'optimum'.[3]

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1. Efforts of Governments to protect some sections of the society in the wake of inflation by instituting price controls according to its own preference pattern (controlling prices of food articles, industrial raw materials or products of some basic industries) would further generate a system of taxes and subsidise which may or may not be growth inducing.

2. The smaller monetary base of an underdeveloped economy (the lower ratio of money to national income) further restricts the effectiveness of the resources mobilizing benefit of an inflationary tax.

3. G. S. Dorrance in a cross-country study based on statistical evidence has suggested that a 2.1 per cent might be the 'optimum' rate of price increase for underdeveloped countries aiming at high growth rates. (Vide: Inflation and growth - Statistical evidence; I.M.F. staff papers, March, 1966).

(B) The goal of 'Structural efficiency' :-

As stated earlier Johnson emphasised this aspect of monetary management in an effort to apply normative criteria to the conduct of monetary policy. We have to see how the banking system (i) as a provider of payments mechanism brings about a socially optimum holding of money and (ii) as an 'allocator of saving into investment brings about optimum allocation of financial resources of the community. In regard to (i) he suggests that interest should be paid on checkable and demand deposits so that a competitive banking system will ensure socially optimum use of the payments mechanism. But for the reason that currency (which is non-interest bearing) competes with demand deposits as alternative means of payment the condition of optimality is violated. Again since banks are experiencing large economies of scale in the operation of the payments mechanism and on the lending and investing side of business this would indicate the "social desirability of operating the banking business as a public utility." A more practical solution to reduce the cost of payments mechanism would be to have a sort of national 'Giro' system which Britain is in the process of adopting so that banks will have to compete with them. Concurrently the practice of Central Banks holding reserves from commercial banks at zero rate of interest militates against the capacity of banks to create deposits and the practice amounts to an implicit tax. In the same way when banks are subjected to interest

regulation while other financial intermediaries are not the allocation of saving and investment is not socially optimum, and amounts to a tax on the banking system. To regulate interest rates of other intermediaries would be a 'second best' solution. It is, therefore, suggested that "improvement in social welfare will be attained by mitigation of special implicit tax burdens which existing techniques of monetary control impose on the banking system".[1]

We use the term 'structural efficiency' here as a catch-all phrase to denote all those changes needed for keeping the existing monetary and financial structure in a condition of efficient working. The whole problem is likely to ramify in a vast terrain of details but to keep to the essentials of the matter it may be asserted that for underdeveloped countries keeping their financial system structurally strong, cohesive and in an efficient form is a concomitant of the growth objective. The element of diversity in the interest rate structure in India

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1. It may be noted that Milton Friedman in his discussion of an "optimum quantity of money" deals with the implications (of his analysis) for aspects of financial policy (other than the growth in the quantity of money) by insisting on removal of prohibition of interest on demand deposits; payments of interest on balances held at the Federal Reserve System; 'if feasible to extend payment of interest to vault cash held by commercial banks as well as supporting 'desirability of minimising restriction of entry into banking' to bring the interest paid on deposits closer to the nominal yield on physical capital' (vide Milton Friedman, "Optimum Quantity of money and other essays" Macmillan (1969) P. 47).

and other underdeveloped countries is a matter of common knowledge.[1] There is regulation of interest rates on deposits and advances of commercial banks and there is the whole problem of an appropriate interest rate structure in India. The diverse structure of banking together with the methods of lending affects allocation of banking resources in an important way and when thought of in terms of the demands made by planning leads to consideration of various issues ranging from ownership (whether private or nationalized), to the growth of the banking system itself. Now it is inherent in the nature of financial systems that they have varying patterns from country to country and there could not be any sanctity attached to a particular pattern or structure.[2] The question to be asked is, given the structure, are we entitled to say from a normative point of view whether its performance meets the criterion of efficiency. We may further have to know whether any changes within the structure - structural transformation - are needed especially when we consider it in relation to an underdeveloped economy.

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1. Refer U. Tun Wai "Interest rates in the organised money markets of underdeveloped economies" - I.M.F. Staff Papers - August, 1956.

2. Great many diversities in the financial structure of developed countries are cases in point. The French banking system functions with four big nationalised and many other types of private banks while the British system of branch banking and the U.S. system of unit banking all are structurally different and may or may not be efficient.

The range of problems briefly hinted at earlier however shows that the issue does not lend itself to easy and simple generalisation. It is nonetheless evident that inclusion of this goal in the list of objectives would help formulation and evaluation of monetary policy in its proper prospective. It may be pertinent here to note what B.K.Madan, Ex - Deputy Governor, Reserve Bank of India had to say on the issue: "I have referred to the structural framework for monetary policy in India as this aspect has been little considered. The significance of the structural differences from the point of view of comparative effectiveness of monetary or Central banking policy needs to be examined more closely than has been done so far and offers considerable scope for research work."[1]

It is not difficult to find a plethora of similar statements in the various writings on Indian Monetary Policy, asserting that structural and institutional - changes are essential without which traditional Central Banking Policy will not be effectively operative.

It may well be argued that structural changes are always slow and cannot be hurriedly imposed on

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1. B. K. Madan - Aspects of Economic Development, Allied Publishers, Bombay (1964) P. 152.

the system.[1] It is precisely for this reason that we have to have some normative criteria to judge whether the existing structure is 'efficient' and/or the needed structural change has taken place. This is more relevant and more pressing for an underdeveloped economy.

As we saw earlier Tinbergen would regard structural efficiency as an aspect of qualitative policy. It may mean making the existing structure work with more efficiency (for instance if under a condition of perfect competition immobility hinders the efficiency solution then by removing immobility efficiency may be increased)[2] or it may mean bringing about changes in the structure. As

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1. Therefore, it may be argued, it is an aspect of long term policy. If monetary policy is concerned with short run stabilization it cannot just pay heed to this long term evolutionary aspect. However, as we saw earlier, the distinction between short run and long run character of monetary policy is not clear and that it possesses both the characteristics.

   It may also be noted that in regard to structural changes in the fields of money and banking they do not always and invariably involve a long term process of fruition. The very fact that the banking industry came to be regulated in its very early phase of evolution in most of the countries in the world is a proof of the need for keeping the system structurally efficient. Whether the regulation was for good or bad and whether the regulating authorities did their job with any such explicit or implicit motive and with more or less success is beside the point.

2. We do not pay regard to the qualification made to this traditional type argument by the Theory of Second Best.

Tinbergen sees the matter:[1] "We can influence the type of movement an economy is able to perform by influencing the structural constants of that economy". As we know the difficulty with qualitative policy is that of subjecting it to empirical tests but Tinbergen would argue "here we even have a possible method of dealing systematically with past, atleast, of structural change: we may formulate certain criteria regarding the type of movement we prefer and then find out which ratios of the coefficients will satisfy these criteria in the best way. It may, for example, be asked for what values of the structural coefficients is the average damping degree of all components of the fluctuations a maximum."[2]

It could easily be seen that in regard to the monetary (financial) system structural aspects are far more important and relevant. The mixed banking system of the continental European countries; the 'ratio-conscious' system[3] of Britain and whole set of varieties in many other countries would show how structural characteristics are important in the fields of money and banking. To the extent we are in a position to derive any model of these structural inter-relationships with specific values we may be in a position

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1. J. Tinbergen: Ibid. P. 157-60.

2. Tinbergen Ibid.

3. British banks are said to possess a fine and strong tradition of 'ratio consciousness' which formed the basis of British banking for decades till it was legalised into 'reserve requirements' in the post-war years. Refer Crick and Wadsworth, "Hundred Years of joint stock banking", London 1958 P. 39.

to judge the working of the monetary system in a much better way. Pending that we should enquire on a priori reasoning and on normative basis whether and how far for a given system 'structural efficiency' is achieved.

The heterogenity in the monetary (financial) structure of an underdeveloped economy makes such consideration all the more essential and thus should necessarily and legitimately be an important constituent in the goal function of its monetary authorities.[1]

The issue has been touched upon in a cogent and impeccable manner by P.R.Brahmanand when he states that 'national financial integration is an important goal' and that 'the structural approach seeks to look at banks in terms of their relation to other sectors in the economy and considers those sorts of changes in the pace, pattern and direction of economic development and economic policy

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1. It may be of relevance to note here what another student of Indian Monetary Policy has to say in this regard: "although most of the elements constituting a money market are present in India, yet we do not have a developed money market which can give monetary policy a meaningful concept" ... "The need for creation and expansion of financial institutions, particularly of financial intermediaries is paramount for a developing economy. For an underdeveloped country, probably the biggest single objective of monetary policy is to create and control these institutions". Refer: J.D.Sethi - "Problems of Monetary Policy in an underdeveloped country" - Asia publishing House, Bombay. (1961). P. 103.

as would bring about a structural change in the relative role of banks in the national economy both as mobilisers of loanable funds and as allocators of loanable credit."[1] Significantly Brahmananda advocates in this regard 'changes in interest policy' as Johnson and Friedman have done in their treatment of the 'structural efficiency' and 'financial Policy' discussions.

The incorporation of structural efficiency as a policy goal seems both justified and overdue.

THE AVOWED POLICY GOAL OF 'CONTROLLED EXPANSION' OF THE RESERVE BANK OF INDIA.

The Reserve Bank of India in its various publications and its officials have emphasised that their policy is directed towards achievement of the goal of 'controlled expansion'. The general logic behind the concept is both simple and interesting. It is argued that in a developing economy money supply will have to increase (i) to meet increased demand for money consequent upon development and (ii) to feed the process of monetisation as the non-monetised sector shrinks progressively. Even if the monetary

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1. 'Economic Policy and programme' - a symposium - Indian Merchants' Chamber, Bombay (January 1970). P. 27.

2. The term is perhaps due to Governor H.V.R. Iengar. See also "The Reserve Bank of India, functions and working", Reserve Bank of India (1970), P. 34 wherein it is stated: "In a developing economy, the .. keynote of monetary policy is what may be called 'Controlled Expansion'.

authorities are aware of a given trend value of velocity money supply will have to grow proportionately more than what is justified by the increase in real output on account of the 'monetisation' need. The emphasise is on 'expansion' and to treat money as a luxury good. However continued Government budgetary deficits lead to secondary expansion of credit hence policy will have to be directed towards keeping in restraint this secondary expansion of credit ('control' aspect) though as the Bank emphasises "while exercising restraint care will have to be taken that the legitimate requirements of production and trade are not affected adversely".[1] In the same breath the Bank however also mentions "there have to be some priorities within the area of legitimacy too. The monetary authorities have also a positive responsibility for channelling credit to desired sectors". This latter part then seems to belong to the 'expansion' aspect of policy and is the qualitative part of it.

It may be asked whether this policy goal represents a 'consensus criterion' or a 'conflict criterion' (conflict of interests). As the rationale of the criterion given by the Reserve Bank stands, it is a 'conflict of interests' criterion.

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1. Ibid P. 34.

2. These terms have been used by C.S.Shoup in respect of goals of fiscal policy. Vide C. S. Shoup, "Public finance". Ibid P.21-22.

On closer examination one may find that the policy goal is more of a type of 'adhoc theorising' rather than representating any systematic efforts to examine its implications in details. It is true that public authorities, (such as monetary authorities) have to formulate their policy programme in an epitomised form but then we have to ask whether the term is for public consumption - which it is not - or can pass the test of logic and economic exercise. From an acadamic point of view the 'expansion' aspect has been put in its proper perspective. But when it is clearly stated that 'continued budgetary deficits' create the need for control then it more or less implies that there would be no problem of control were the budgetary deficits not operating as a constraint on the expansion - oriented (i.e. policy directed towards meeting the monetary needs for expansion) and presumably well formulated policy. The phrasing of the term and the explanatory part of it suggest that the monetary authorities do not feel that their 'expansion' programme should have any disturbing effects (either on account of over or under expansion than warranted by the legitimate requirements consequent upon growth). No doubt the normal annual variation in money supply (which applies to both developed and underdeveloped countries) may have some disturbing effect but its magnitude and impact could not be so large as to warrant corresponding or follow-up control measures. If so, all Central banks whether in developed or underdeveloped countries have to serve the policy goal of controlled expansion. It follows therefore, and it is so explicitely stated

in the quotation from the Reserve Bank of India cited earlier that control has to be exercised to deal with secondary expansion of credit following continued budgetary deficits of the government.

It may be pertinent to note here that in order to provide a logical basis to the control aspect of policy R. J. Bhatia[1] suggested that Central bank's claims on the Government sector may be treated as an autonomous factor and the claims on private sector as a policy-induced variables. If this reasoning is accepted the Reserve Bank of India does no more of any 'controlled expansion' than any other Central Bank in either a developed or underdeveloped country may be doing when it undertakes monetary expansion. It seems, therefore, plausible to argue that from an academic point of view the policy goal of 'controlled expansion' does neither put the policy programme in its proper perspective nor does it add any dimension to Central Banking policy either for India or for any underdeveloped country. It may be contended that a strict and devoted perusal of the policy goal is likely to have injected a sense of complacency with the policy makers and may have precluded resort to or deliberations for bringing about needed structural changes to make their policy measures more effective. It is clear that the

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1. R. J. Bhatia - "The role of monetary policy in price stability - the Indian case", Review of economics and statistics (1961).

meaning attached to the term 'controlled expansion' specifically refers to 'controlled expansion of credit'. The need for control may be done away with if expansion is optimal in character. If however it is argued that control has often to remain qualitative and directional in nature then the use of the term may be justified but then such is the nature of policy with other Central Banks too. Moreover, we have to see whether the qualitative (selective) instruments of control have had any success in achieving this objective. We propose to deal with the issue of selective credit controls in another chapter but if we look to what the Reserve Bank of India thinks about them they say: "In India, such controls have been used to prevent speculative hoarding of commodities like foodgrains and essential raw materials to check an undue rise in their prices".[1] Now one of the reasons for relatively low success of selective regulations has been the availability of non-bank sources of finance and to that extent it could be argued that the control aspect of policy did not produce good results and only expansionary policy has remained in operation. The point to be made here is that preoccupation with the concept of 'expansion together with control' has precluded consideration of framing what may be called an 'optimum monetary requirements' budget. This in itself

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1. "Reserve Bank of India, Functions and working" (1970) P. 58.

is a stupendous task but paying attention to it necessitates a reference to the structural efficiency aspect of monetary management which a simple policy goal statement like 'controlled expansion' does not.

Again arguing that "one can conceive of a policy which in the long run aims at a secular expansion of credit but in the short run seeks to control its rate of expansion - a policy of what the Reserve Bank has termed 'controlled expansion",[1] does not rationalise the goal. For any economy (whether developed or underdeveloped) experiencing growth in real output the 'long run' aim of 'secular expansion of credit' is relevant and so is short run concern for control. The Reserve Bank could not claim any meaningful specification of its policy goal as distinct from that in a developed economy by resorting to usage of such terms. Usage of the terms 'keeping the economy on the trend path of evolution' and 'minimising deviations from the trend path' as stated earlier seem to be more appropriate as they would apply to both types of countries and, what is more, thinks of 'control' to be operative in either direction as warranted by the state of the economy.

The conclusion seems inescapable that the term 'controlled expansion' has great popular appeal but is less than a rational hypothesisation of the policy goal.

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1. "Evolution of Monetary Policy in India", Reserve Bank of India Bulletin, April, 1966 P. 342.