

## Chapter VII

RELATION BETWEEN THE STATE AND THE CENTRAL BANK.The Government Needs for Borrowing on Current Account.

Just as an individual businessman or a firm may not possess funds when they are needed for the purpose of making payments so also a government may not have liquid cash ready with it sometimes, to meet its day to day liabilities. The need for borrowing is as obvious in the case of a government as in the case of a business enterprise. New taxes can be levied only once in a fiscal year while it may not be feasible to provide for all the expenditures during the year for, some of them may be quite unanticipated and, therefore, incapable of being provided for before hand. It is also likely that tax collections, though already aimed at a certain target, may fail to come up to the expectations due to events which may transpire between the time of budgeting and that of collection. Again, as government collects huge sums every year by way of taxes, there is the need for a banking institution with which government funds may be kept before they are finally disbursed. For managing the financial affairs of government, there is the need of a banking institution with relative stability and reputation. The Treasury is not suited for this purpose, for it has other responsibilities to discharge.

Historically, the government need for borrowing rather than for a safe repository of government funds, contributed to the emergence to a financial institution which by securing special privileges from the government, steadily evolved into a central bank. Thus, the origin and development of the Bank of England are closely connected with the financial difficulties of the Exchequer. William Paterson, a Scotsman, seized the opportunity of forming a banking corporation known as "the Governor and Company of the Bank

of England" when William III's Government was in need of funds. He could strike a bargain and receive parliamentary sanction for this in exchange for a loan of £ 1,20,0000~~x~~ to be given permanently to the Government. The company was given the right of issuing notes in London.<sup>1</sup> In Holland, the Netherlands Bank founded in 1814 was obliged by a Royal Charter, to grant advances to the State on application from the Minister of Finance upto a certain amount (not exceeding Fl. 15,000,000). This obligation was imposed upon the Bank <sup>by the</sup> Act of 1888. The Bank was given the power of issuing bank notes.<sup>2</sup> The Bank of France was founded by Napoleon Bonaparte in 1800 partly by the aid of the State but mainly with private capital. The Bank had close connection with the State from the very beginning of its career. It has been continuously a banker to the Government.<sup>3</sup> The Bank was given an exclusive right of note issue in Paris.

The above examples indicate that the relation of the central banks with the State, in the capacity of a banker to the Government, gave them a prominent place among their competitors. This prominence was considerably enhanced when the power of issuing notes was exclusively given to the central bank. Amongst the three factors, namely, the practice of keeping government's funds with the central bank, the exclusive power of note-issue and the government need for borrowing, the government need for borrowing stands out as the most powerful factor which contributed to the establishment and growth of central banks.

1. 'Foreign Banking Systems' Ed. H. Parker Willis & B. H. Beckhart, London, 1929, p. 1146.
2. Ibid, p. 732.
3. K. Mackenzie. 'The Banking Systems of Great Britain, France Germany and the United States', III Edn. 1947, p. 130.

The other two privileges of the central banks were subservient to the need for government borrowing in the sense that they smoothed the path of government for borrowing from central banks in an hour of need.<sup>1</sup> As a ransom for granting loans to the government, the central banks could exact protection and privileges from the latter. Thus, <sup>when</sup> during the period of Napoleonic wars the reserves of the Bank of England were seriously affected due to excessive borrowing by the government, the Bank was at once rescued by suspending cash payments. This made it convenient for ~~banks~~ the Bank to meet government demand.<sup>2</sup> In the case of the Bank of France too, the Bank could obtain the extension of its exclusive privileges by offering special concessions to the government.<sup>3</sup>

Apart from this sort of direct relation between the State and the central bank as a borrower and lender respectively, the central bank can counteract the deflationary or inflationary effects of government fiscal operations. This task can be undertaken by no other institution than a central bank which is in close contact with the day to day trends in prices, employment and industrial activity. The disturbing influences on the supply of or demand for funds caused by the Treasury operations can be offset by the central bank by putting enough credit into the market or by taking enough out of it.<sup>4</sup>

#### The Status of Central Banks.

From the early beginning of central banking, there was a close relationship between the central banks and their respective

1. R.G.Hawtrey, 'Art of Central Banking' 1932, p.266.
2. Vera C.Smith, 'Rationale of Central Banking' 1936, p.12.
3. C.F.Dunbar, 'Theory and History of Banking' 1906 p.155.
4. Kisch & Elkin, 'Central Banks' p.104. London 1928.

governments. This does not imply that the State exercised direct control over central banks. As the central banks were conferred upon the exclusive power of note issue by the authority of the State, it is true that the central banks could not be free from government supervision so far as this special function of a central bank was concerned. But even here, so long as the central bank of a country acted within the bounds of law which gave it the power of note-issue, government supervision was only nominal. In the day to day credit policies, the central banks were free from government interference.

This sort of freedom of central banks was quite in keeping with the way in which they were constituted. Like all other joint stock enterprises which ~~was~~ began to spring up with the mechanization of production, the central banks were also privately owned. Their capital was subscribed by private share-holders. As these persons had ~~given~~ risked their capital, they would not tolerate the interference of the State in the management of the bank, as such an interference of the State was calculated to adversely affect their legitimate profits. These owners of the capital of central banks would certainly claim-and they were justified in doing so - a vital say in the affairs of the banks especially in a free enterprise economy.

The Bank of England supplies a unique example of a privately-owned central bank which was floated originally as a joint-stock bank specially distinguished from other similar banking enterprises by its position as a lender to the government. It can be said to have assumed a statutory form of a central bank by the Act of 1844. But, even after this new privilege was granted to it, it continued as an independent institution. Elsewhere the central banks were established by the initiative of the State and hence the State exercised some right

as regards the appointment of the managing personnel. But, for the purpose of raising capital, the example of England was followed. Thus, in France, though the Governor and two Sub-Governors were to be appointed by the government, the share-holders were represented by a Board of 15 Regents elected by two-hundred largest share-holders.<sup>1</sup> The Bank of Netherlands, founded in 1814 by a Royal Charter, was privately-owned and the members of the Managing Board were elected by the share-holders. The National Bank of Belgium was also a privately-owned institution, though the Governor of the Bank was to be appointed by the government. In the case of the Reichsbank of Germany also the share-holders of the Bank were represented by a council elected by them. With the exception of the State Bank of Russia, which was founded in 1860 as a State-owned institution, all of the older central banks were established by private subscriptions. The share-holders therefore, naturally occupied an influential position in the management of the central banks.

It is to be noted that in most of the instances cited above the governments did not dissociate themselves completely from the management of their respective central banks. In fact they would have established their complete control over their central banks. But, "as the capital was raised by private subscriptions, the share-holders' representation had to be accepted." As privately-owned institutions, the central banks had to be independent. But this reason alone does not sufficiently account for the theory of 'independent' central banks. There were claimed ~~was~~ certain special advantages for an 'independent' central bank, which considerably strengthened the case for freedom of central banks from government interference.

1. K. Mackenzie. Op.Cit., p.129.

The most outstanding among these advantages is that an independent central bank can check an extravagant government from borrowing excessively from the central bank. A government which is extravagant cannot gather enough from the people by way of taxation for, in so doing, it will have to face popular opposition. It is likely that it would readily exploit the situation to its advantage by tapping the central bank, if it is at its beck and call. Even if a government may not frequently resort to a central bank for funds, it may take advantage of it on occasions such as the time of election when it may not like to offend the electorate by taxing heavily in order to meet its increasing liabilities. By means of central banking machinery, the government can easily utilize the funds of the entire banking<sup>system</sup> in the interest of the voters by distributing these funds among them in the form of 'public works', 'relief' and miscellaneous subventions.<sup>1</sup> This sort of deficit financing on the part of government may prove inflationary at times and may involve disastrous economic consequences for the community. An independent central bank can resist such attempts on the part of government and can save the community from economic hardships. It has been further argued that political control of central banks of issue is likely to create the danger of currency inflation. It is likely to make central banking policies biased in favour of the interests that largely constitute the party in power. It would disturb the continuity in the day to day operations of the central bank, which is essential for a sound management of a country's credit and money. For, a government-controlled central bank would tie down the fates of the policy making personnel of the bank with the fluctuations in the fates of political parties.<sup>2</sup>

1. H. Parker Willis, 'Theory & Practice of Central Banking', 1936 p.331.

2. Kisch and Elkin, Op.Cit., pp.20-21.

The above considerations continued to exercise a strong influence on those who were responsible for raising new central banks or reorganizing the older ones before and just after the First World War. That war considerably intensified the belief in the danger of a State-controlled central banks. The status of central banks newly established or reorganized during the reconstruction period following the First World War generally contain a clause or a sentence emphasizing the need for the independence of central banks especially in the case of management. This tendency finds clear expression in the resolutions adopted at the Brussels Conference of 1920 and at the Geneva Conference of 1922. The principle of an 'independent' central bank was restated later on at the Monetary and Economic Conference of 1933.<sup>1</sup> However, in the later thirties, the pendulum began to ~~take~~ take a swing slowly to the ~~otherwise~~ other side. Despite that, the amendment to the Statute of the National Bank of Belgium passed in July, 1937, attempted to safeguard the Bank's independence, though strict government ~~supervision~~ supervision was to be exercised over the Bank, lest it might adopt measures contrary to the "interests of the State". In the terms of reference of the Netherlands Commission of Banking appointed on 4th. March, 1937, it was clearly stated that the Commission was to examine the extent to which the status of the Netherlands Bank needed to be modified 'without impairing the Bank's independence'.<sup>2</sup> This accepted view about the position of central banks vis-a-vis the State was applied also to the newly established central banks the main among which are the Federal Reserve System of the U.S.A., the central banks in British Dominions and India.

1. League of Nations, 'Money and Banking, 1937-38, Part I. p.81 (foot note 8).

2. Ibid, pp.82-83.

Arguments Examined.

The arguments advanced for the freedom of central banks from political interference, imply <sup>that private</sup> ownership as against the State ownership, would best serve the purpose. Though ~~the fact~~ it is beyond contention that central banks should be free from political interference in order to remove the dangers noted on the previous page, it is difficult to maintain that private-ownership of the banks is a successful expedient to achieve this end. The board of Directors as the representative of the share-holders can hardly be relied upon as an unbiassed and impartial body, for, there is no assurance ~~and~~ that it would not be constituted of narrow sectional interests. It can be a body representing different economic interests in a country only if the share-holders are scattered over ~~all~~ different economic interests such as commercial, agricultural, industrial and various income-groups. But this can hardly be the case in any country. It is more likely that the majority of share-holders may belong to a small community whose economic interests may be in sharp contrast to those of the whole nation. In order to secure unbiassed credit policies, the members of the Board of Directors should be drawn from various fields of economic activity. For this, Government interference in the management of central banks is indispensable. This was clearly recognised in the thirties of the present century. During that period the governments of several countries actively interfered in the management of their central banks in order to make the Board of Directors sufficiently broad-based and representative of different economic interests. Thus, in France, by the law of July, ~~22~~ 1936, the Regency Council (the members of which were previously appointed by two hundred largest share-holders) was replaced by a General Council the members of which were to be



drawn from various groups representing non-banking occupations, social and economic interests, various economic associations such as consumers' co-operatives and chambers of Commerce etc. Similarly in Argentina, the composition of the Board of Directors of the central bank was rendered broad-based at the same time as in France. Though the twelve Directors of the central bank to be selected by the government were to represent mainly the banking interests, they were to include an agriculturist, a live-stock producer, a businessman, a manufacturer, and a government delegate. In Denmark also, by the law of April 1936, though 15 Directors out of the total of twenty-five were to be appointed by the general meeting of share-holders, they were to possess thorough knowledge of trade, industry and agriculture.<sup>1</sup> These measures do not radically change the system of management, but they point out an important fact that to make the Board of Directors really unbiassed and representative of different economic interests, its composition should be varied. This cannot be made possible without government interference.

As regards the necessity for the stability of those who are immediately responsible for the credit policies of a central bank, in order to impart continuity to such policies, it can be said that such a need exists also for all government departments. This particular requirement of the government has been met by banking the making the permanent executive of the State free from party influences. The appointments and tenure of civil servants depend upon certain rules. In the case of the personnel of the central bank, the same procedure can be used. One can go still further and say that the management managerial personnel of the

1. Ibid ,p.82.

central bank should be given a constitutional safeguard in order to make it completely free from party influences. Such safeguards are now-a-days provided for the members of the Judiciary. They can be extended with benefit to the highest personnel of the central bank. Continuity in the policies of central bank does not necessarily require that the policy making personnel of a central bank should be responsible to share-holders. It would be more correct to say that the abolition of such a system and substitution of the one recommended above would go a long way in securing the objective.

The contention that an independent central bank can act as a check to the excessive borrowing on the part of Government, *prima facie* sounds correct. But, though in theory, this view can be accepted, in practice there is no evidence to corroborate it.

#### Independence in Practice.

How far the theoretical independence of central banks has been able to contribute towards sound monetary and credit policies is difficult to ascertain. In fact the older European central banks can be hardly said to have ~~earned~~ owed their independence to a conscious recognition of the theoretical advantages claimed for an ~~easy~~ independent central bank. Their independence, is largely explained by historical accident. The Bank of England, as pointed out before, emerged as a joint-stock private enterprise and <sup>due</sup> to its privileged position, it was conferred upon the status of a central bank. The example of England was generally followed by other countries. Further, as the independence of central banks hardly came in the way of their being exploited for the needs of the Treasury, it was not seriously called in question. This fact largely held good in the

case of the Bank of France. In the Napoleonic regime, the Bank of France, though enjoying a nominal independence, was gradually involved in the bold operations of the French Treasury. By the law of 1806 the Bank ~~as~~ was subjected to government control and since then it was often available for the needs of the Government. In spite of this, the case for State ownership was urged with great ability by a minority of the Chamber of Deputies at the time of passing the law of 1897. The scheme was, however, turned down. It is interesting to note that State-ownership of the Bank was rejected not out of any deference to the advantages generally associated with the independence of central bank. The reasons advanced for an independent central bank were altogether different. It was argued that in case of foreign invasion, a public bank like any other public establishment would be subject to seizure by a hostile army, while a bank under private ownership would be exempted like other private property by the laws of war. In support of this view the ~~a~~ decision of the German Government recognizing the immunity of the Statesburg branch of the Bank in the war of 1870 was cited. The same arguments were used in 1898 in Germany when the question of the absorption ~~of~~ by the State had come up at the time of passing the bill for extending the charter of the Reichsbank.<sup>1</sup>

The Bank of England among the ~~old~~ older central banks and the Federal <sup>Reserve</sup> System amongst the new ones are generally considered to be representative examples of central bank independence. But even in these two cases, it is beyond all doubts that the Treasury interference has been strong from the very beginning.

#### The Bank of England.

The Bank of England from its very establishment had all

1. Charles F. Dumber. Theory ~~and~~ History of Banking. II Edn. 1906 p.153.

the features of an independent central bank and the relations between the Bank and the government were those of a lender and a borrower. In the past, no doubt, the Bank seems to have strongly objected to the excessive borrowing by government, but it had to submit to the will of the government, of course, not without some advantage to the Bank in bargain. The Bank had the motive for the renewal of the charter, while the government was in need for funds. Each time an extension of a loan by the Bank to the government was accompanied by the renewal of the charter of the Bank. Thus, between 1694 and the commencement of the nineteenth century the Treasury benefited no less than seven times by the successive renewals of the charter and this was in addition to the short-term accommodations given by the Bank in the ordinary course of its transactions.<sup>1</sup> This was a sort of mutual bargain and the independence of the Bank could hardly be expected to offer any resistance to the demands of the extravagant ministers. Of course, during this period, the Bank was not a central bank, despite that the excessive lending by the Bank to the government could not be justified on any ground. The Bank Act of 1694 strictly prohibited it to make advances to the government without the express authorization of parliament. Despite that during the French wars, the Bank was virtually compelled to comply with government requirements to any extent.<sup>2</sup>

During the First World War, the government practically controlled the maximum and minimum rates through its operations in Treasury bills at fixed rates. The government remained in full control of the situation even after the war until 1921, when the system of selling Treasury bills by tender was restored. In times of emergency such as that of war, it can hardly be expected that

1. Vera Smith . Rationale of Central Banking, 1936 p.17.

2. Ibid p,12.

an independent central bank would be backed even by public opinion in resisting the demands of government. At such a time, government is accepted by the public opinion as the sole authoritative exponent of national needs. If the directors of the central bank raise objections to the government's financial measures as being inflationary, they will be overborne. ~~The~~ To call inflation unsound will be to invite the retort that war requires exceptional measures and that ~~the~~ the operations of the government cannot be restricted or delayed for the moment for want of the means of payments.<sup>1</sup> In normal times, the possibility of excessive government borrowing is much less.

Not only that an independent central bank has not been able to resist the demand of government, but sometimes government interference has proved beneficial from the community's point of view. The Bank of England displayed incompetence to successfully shoulder its responsibilities during the first sixty years of the 19th Century. It permitted the paper pound to depreciate, prices to rise and the exchanges to fluctuate especially when cash payments were restricted. At the same time, it repeatedly denied that there was any relationship between these phenomena and its own activities. The passage of the Act of 1844 by huge majority was evidence of a general lack of confidence in the ability of the Bank to carry out properly its responsibilities.<sup>2</sup> On several occasions government interference proved advantageous. In the deflation of 1822, the government had to bring pressure on the Bank to reduce its rate from 5 per cent. to 4 per cent.

1. R.G.Hawtrey, 'Art of Central Banking', 1932 p.268.

2. J.Viner. Studies in the Theory of International Trade, 1937, p.255.

and the volume of circulation was increased on the initiative of government.

Even after the Bank Act of 1844, by which the Bank of England came to possess many of the symbols and characteristics of a central bank, the Bank failed to control the crisis of 1847.

The Bank followed a low ~~fixed~~ discount rate policy during the boom of 1846-47 which provided a stimulus to reckless speculation, and investing. <sup>strangely</sup> ~~Strongly~~ enough, for this policy of the Bank, the government of the day along with the Parliament and the free-banking opinion in general rather than the Bank are blamed by modern critics for not stopping the Bank from lowering its discount rate.<sup>1</sup> Ultimately, the Bank rate was raised in April, 1847 on the advice of the committee of the Treasury who had absolutely no interest in a lower Bank rate.<sup>2</sup>

#### The Federal Reserve System.

The Board of Governors of the Federal Reserve System of the U.S. is another important example of an independent central bank. But an examination of the relationship that has developed unto the present day between the Board of Governors and the Treasury presents a sharp contrast between the theoretical independence of the Board of Governors and the ~~dominant~~ <sup>dominant</sup> control and political pressure exercised by the Treasury over it in practice. Though the capital of the Reserve Banks is <sup>subscribed</sup> ~~subscribed~~ by the member banks, the members of the Board of Governors are appointed by the President with the advice and consent of the Congress.<sup>3</sup> In the beginning the position of the Board of Governors vis-a-vis the Treasury was undefined but according to a ruling of the Attorney General of the U.S.,

1. Sir John Clapham. The Bank of England-A History. Vol.II, 2 1945 p.192.

2. Ibid p.201.

3. K.Mackenzie, Op.Cit., p.219.

the Board was declared an independent bureau or establishment of the Government, free from any government department save in so far as it chose of its own accord to be bound by such control. The Secretary of the Treasury was from the beginning appointed on the Board of Governors so also was the Controller of Currency. But the Board's relationship with these two officials was to be co-ordinate and when they were to sit with the Federal Reserve Board, they were to act as members of the Board and not in their official capacity.<sup>1</sup> This position, though clear and definite in theory, could hardly be realized in practice. From the very beginning, the Secretary of the Treasury could secure a practical majority for any measure of policy that he might choose to advocate. The board became more and more dependent upon the Treasury dictation and in fact, if not in theory, a <sup>portion</sup> ~~part~~ of the organisation of the Department. The system may be called free from political influence in the sense of <sup>the absence of</sup> pressure to make particular loans. But to shape policies either in the interest of given classes or in the interest of conditions favourable to particular kind of business, <sup>the</sup> system <sup>was</sup> ~~was~~ never free from Treasury control.<sup>2</sup> An American ~~authorities~~ authority on the Federal Reserve System stresses with the same emphasis the growing menace of political pressure upon the Reserve System thus: "Inroads by politics upon the independence of the Reserve System have already reached the proportions of a serious threat to its <sup>integrity</sup> ~~integrity~~. It is this ~~growing~~ growing political domination which is by all odds the gravest danger confronting the system".<sup>3</sup>

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1. H.P. Willis and W.H. Steiner. 'Federal Reserve Banking Practice' 1926, p. 29.
  2. D.W. Dodwell. 'Treasuries and Central Banks'. London 1934, pp. 184-85.
  3. Warburg. 'The Federal Reserve System: its origin and growth' Vol. II, p. 843.

In 1917 the Board displayed an independent attitude and lodged a protest against the borrowing plans of the Treasury. But Secretary Mc Adoo of the Treasury threatened to take over the gold reserves and entire funds of all the banks for the purpose of winning the war. The Board had to acquiesce in the policy of the Treasury. The Secretary directly contacted the Reserve Banks, ignoring the Board of Governors. The Board reluctantly adopted the policy of low discount rates equal to the interest on government securities because 'the Treasury Department was in a position to override the Board with the assistance of the Reserve Banks'.

Throughout the inter-war period, the Board of Governors worked in co-operation and harmony with the Treasury. It facilitated the borrowing programme of the Treasury by undertaking open market operations for the purpose of maintaining 'orderly conditions in the bond-market'. During the Second World War, as is usual in all national emergencies, the Federal Reserve Authorities co-operated whole-heartedly with the Treasury for the purpose of finding sufficient financial ~~manana~~ resources for war mobilization. The danger of inflation was intensifying as the Government expenditure began to mount up with rapid strides but the Federal Reserve Authorities were unable to go against the easy money policy of the Treasury.

From strictly a legal point of view, the Board of Governors can be said to have become more independent of the influence of the Treasury <sup>from 1935.</sup> For, by the Act of 1935, the Secretary of the Treasury and the Comptroller of Currency were removed from the Board.<sup>1</sup> According to an official of the System, the establishment

1. Board of Governors of the F.R.S. Banking Studies, 1948, p. 5259.



of the Board is not a part of the Treasury or any other government department. It can report directly to the Congress. The funds by which it is supported are derived not from Federal appropriations but from assessments levied on the Reserve Banks.<sup>1</sup> But even after this clear description of the position of the Board, in reality the Reserve Authorities are far from <sup>being</sup> independent. This is well brought out by the post-war monetary policy which disclosed the predominance of the Treasury in monetary matters.

The crux of the problem of monetary management in the post-war period was the control of inflation. So far as the monetary instruments of this control were concerned, they were the flexibility of the structure of interest rates and the control of bank reserves. Both instruments could not be used by the Federal Reserve Authorities for the Treasury was prejudiced against their use. Under the exigencies of the management of public debt, the Treasury was wedded to the policy of low interest rates. Throughout the post-war period, it is the attitude of the Treasury rather than that of the Federal Reserve Authorities, that has been influential in affecting the quantity of money. Secretary Snyder of the Treasury, it is said, wanted to stop inflation but not by monetary restriction. The problem in his opinion could be attacked better by higher taxes, selective credit controls and even by direct prices and wage controls.<sup>2</sup> One of the instruments of selective credit control was Regulation W designed to regulate the terms of instalment credit which contributed significantly to the post-war inflation. But the Regulation was discontinued by a Congressional Resolution from November, 1947 much against the opinion of the Board of Governors of the Federal Reserve System. The attitude of the Board towards this measure can be clearly

1. Ibid, p. 353.

2. Herbert Stein. Monetary Policy and the Management of Public Debt. A.E.R. December 1952, p. 869.

read from a statement released by the Board on October 27th, 1947:

" The continuance of small inflationary pressure convinced the Board that this is no time for the relaxation of terms by banks, finance companies and instalment sellers. Demand for automobiles and many other durable goods specially covered by the Regulation W is still in excess of supply. .... There could not be a worse time to encourage the public to go deeper and deeper into debt".<sup>1</sup> But this opinion of the Board proved only a cry in the wilderness.

The Report of the Sub-Committee on monetary, credit and fiscal policies, popularly known as the Douglas Committee, contains a significant statement as regards the attitude of the Federal Reserve vis-a-vis that of the Treasury towards monetary policy in the post-war period. The Report states that "the Federal Reserve was not willing to assert its independence and force market yields to rise above the yields the Treasury wished to set on its new issue".<sup>2</sup> This is somewhat a misrepresentation of the attitude of the Federal Reserve Authorities. The fact is that immediately after the Second World War and again in early 1948, the Federal Reserve did try to persuade the Treasury to raise the short-term rates but the latter refused to follow the recommendations of the Federal Reserve.<sup>3</sup>

It can be well understood from the above examination of the position of the Federal Reserve Authorities in the monetary framework of the U.S., that whatever may be its legal status, the Federal Reserve Board has to recognize, in practice, the superiority of the executive authority of the Treasury. This is because of the difference in the positions that the Federal Reserve and the Treasury occupy in the public affairs.

1. Fed. Res. Bull., Nov., 1947 p. 1356.

2. Douglas Committee Report - A brief Review by E.A. Goldenweiser, A.E.R. June 1950, p. 395.

3. Lester V. Chandler. Federal Reserve Policy and the Fed. Debt Readings in Monetary Theory, A.E.A., p. 413.

The Treasury is a crucial operating branch of the Government. In the formation of tax and public debt policies, the Secretary of the Treasury ~~xxxx~~ remains in the closest contact with the highest executive authority of the U.S., namely, the President. He is associated with the President more than any other member of the cabinet. The Federal Reserve Authority by the very fact of its 'independence' is far removed from the President. It is evident that considerations of debt management would weigh heavier with the President than those of monetary management, for, the latter do not find sufficient representation as the former do. It is the human factor here that is dominant, whatever may be the theoretical justification for a particular line of monetary action.

But more than this, the factor that establishes the domination of the Treasury over monetary authorities is a very large increase in the magnitude of fiscal operations of the Treasury. The Treasury now can affect as much the quantity of money by causing changes in bank reserves (including liquid assets) as the Federal Reserve Authorities can do. This is, of course, a direct result of the preponderance of public debt in the post-war period. When the Treasury floats new securities and when these are bought by the banks and also by non-bank investors, the quantity of money will be reduced. Again, when the Treasury redeems the maturing debt, the ~~xxx~~ quantity of money would be increased to that extent. Of course, the power of expanding the quantity of money would depend upon the cash balances with the Treasury. Again, apart from the management of public debt, even the day to day fiscal operations of the Treasury can produce significant changes in the volume of money. Increase in the rates of taxes and creation of surplus budgets would produce deflationary effects while the creation of deficits would have the opposite effects.

It is true that these potential powers of the Treasury cannot be used simply to foil the measures of the monetary authorities in case of conflict, for, such a use may have adverse effects on the <sup>situation</sup> over all economic ~~situation~~ in the country. Nevertheless, the very existence of such potential powers of the Treasury is a strong consideration impelling the Federal Reserve Authorities to co-operate with the Treasury to reach working agreements on credit and fiscal policies.<sup>1</sup> If at all the Federal Reserve Authorities oppose the policy of the Treasury, they stand all the chance of being threatened with extinction. Such threats are not only a theoretical possibility but have been actually expressed in the ~~past~~ <sup>past</sup> by the Treasury. For example, in 1933, Secretary Woodin expressed the desire to "crush the Federal Reserve System" and, when pressed for an explanation, gave as his reason, 'the fact that 'he wished to be able to order loans to the government by merely telephoning to the Reserve Banks'.<sup>2</sup>

It is obvious from the above discussion, that the independence of central banks has not been able to serve the avowed purpose for which its advocates recommended it. The legal status of central banks as formally independent private banks under government control or as pure State banks has got but little effect upon their actual credit relations with the government. At the end of 1923, out of the central banks operating in Australia, Bulgaria, Czechoslovakia, Estonia, Finland, Hungary, Japan, Latvia, Poland, Russia, Sweden and Uruguay, only three central banks had more than 50% of their earning assets in the form of <sup>government</sup> government securities. In the case of countries in which the central banks were taken over by the State, the claims over the government represented old debts taken over

1. G.L.Bach. Monetary Policy Formation. Am. Eco. Rev., Dec. 1949 p. 1182.
2. H. Parker Willis, "Theory and Practice of Central Banking" 1936, p. 331.

by the new State banks and no new credit was granted to the government. In five of these countries, direct credit relations of the State banks with the Government were of small importance (i.e., in Sweden, Japan, <sup>Uruguay,</sup> ~~Uruguay~~, Latvia, Estonia) and in the case of Finland the ratio of government claims to total assets was very much ~~reduced~~ reduced.<sup>1</sup>

In the past, if at all the central banks could exercise some restriction over government borrowing, it was less due to their independence. It was more due to the exigencies of the international gold standard which exercised a rigid discipline both on central banks and their governments. Due to the simplicity in monetary management that the gold standard provided, the public could well understand and support the stand taken by the central bank when the country's gold reserves were falling. Behind the voice of the central bank there was a strong backing of public opinion and it is ~~the~~ the latter that is more important for enforcing discipline over any public institution in a democratic society. It is admitted even by the staunchest advocates of the political independence of central banks, that large-scale borrowing to an abusive extent by governments from their central banks is possible especially when the country's currency authorities have no responsibility for its convertibility.<sup>2</sup> It is true that an independent central bank can give a sound advice to government and explain well the consequences of excessive borrowing by government over the economic welfare of the people. Perhaps the central bank is more suited for this task than any other agency in the country. If the government is convinced reasonably well, the central bank would have done its job well. But here, the technical competence and insight of the central bank, and not its independence, that would gain a hearing for

1. Memorandum of Central Banks. League of Nations, Geneva, 1924 p. 57  
2. Kisch & Elkin. Op.Cit., p.22.

its protest.<sup>1</sup>

( In the absence of some established rules easily understandable by the people such as those workably provided by the ~~manipula~~ gold standard system, the chances for political pressure are bound to be present. For, in the absence of set rules, management of money becomes largely discretionary in the hands of monetary authorities who can cleverly manufacture sufficient reasons for justifying their action in an event of public criticism. In the context of discretionary management of money, the fear that a State-owned central bank would be used by certain powerful political interests to their own advantage is not altogether absent even from a politically independent central bank. In this case both the government and the central bank have to face a common menace to public interests. This danger of powerful economic interests dominating the central bank policy, is greater when the central bank is an independent corporation, for, then the scrutiny and examination of its policy cannot be held on a legislative platform as it is possible when the government is responsible for central banking policies. The dangers of the policy adopted by an independent central bank are known to the public only when its consequences assume a serious form. It may be possible to hold those, who might be the agents of the whole mischief, responsible at the bar of public opinion, but, even then, what would have been done could not be undone.

The independence of the central bank fails to provide the very safeguard ~~the~~ against the predatory habits of governments or of those who are active behind them, for which it was so ardently advocated. Need for such a safeguard remains as true and as urgent even today as it was before the world democracies

1. R.G.Hawtrey. Art of Central Banking 1932, p.268.

had begun to rise upon the political horizon.

THE SWING OF THE PENDULUM.

There is no assurance that the remedy of an independent central bank provided against the disease of excessive borrowing by the government will not react unfavourably and would not create disasters for the body economic in other directions. The dangers arising out of an irresponsible privately-owned corporation that is entrusted with the responsibility of the general well-being of the country are equally great and serious. The government, which is responsible for an over-all economic policy of the country, <sup>cannot</sup> leave the monetary aspect of that policy to an agency which is constitutionally independent of government control. The management of the nation's money and banking could be left to a private institution with government control here and there, so long as the governments had not addressed themselves to an over-all economic policy and especially to the task of saving people from the scourges of periodic trade fluctuations. An over-all economic policy of government before nineteen-thirties was to be found only in the exceptional times of war and in such times of emergency all theoretically accepted tests of a sound management of money were shelved. Government interference in the domain of money did not sound unusual at such times, as it was accompanied by similar interference in other fields of economic activity also.

But the depression of thirties called upon all governments to regulate the economic activities in such a way that the distress of trade fluctuations could be avoided. The control of money and credit was essentially considered a strategic measure to control the fluctuations in business. A central bank under private control cannot be guided by the motives and ends that

are open to government. For, private control is generally dominated by the ideas of capitalistic undertakings that are based on profit. A central bank should be a non-profit making institution.<sup>1</sup> In fact, the insistence on government control over the credit system of a country was the result of an increasing emphasis that was being placed gradually on government interference in the free working of an economy just to drive back that economy to its very rationale.<sup>2</sup> Increasing government control in the field of money therefore, was reflecting the end of an era and the dawn of a new one - the decline of laissez-faire and rise of a welfare State.

The degree of direct government control of monetary policy varied from country to country according to the exigencies of the objective for which such control was needed. In countries with organised money markets and financial systems such as United Kingdom and United States, the nature of control was milder and was not carried through essentially by a fundamental change in the institutional set-up of central banks. But in countries, especially economically backward and where government activity was required to penetrate the varied and wider fields of economic activities, the necessity for a legally defined control of central banks was obvious. In the case of British Dominions the gospel of central bank 'independence' was incorporated into the statutes of their new central banks by the English advisors, whose views were thickly lued with the status and working of the Bank of England, <sup>but</sup> it hardly could work satisfactorily in practice. After a few years the subsequent amendments of the statutes brought

1. Key Willis. The Practice of Central Banks. pp. 334-335.

2. Keynes. General Theory, p. 380.



the central banks within the range of legally defined control of government. It is interesting to note that the Royal Commission on Banking and Currency in Canada, 1933, was especially influenced by English advice in matter of private ownership of the Bank, <sup>of Canada.</sup> But, no pressure was forthcoming for such a form of constitution from Canadian sources. It is doubtful whether one word explicitly in its favour can be found in the thousands of pages in the evidence before the Royal Commission. "The three Canadian Commissioners, although divided upon many points, were united in condemning it".<sup>1</sup>

In spite of this, the then conservative administration in Canada was successful in establishing the central bank, the Bank of Canada, on accepted lines. It commenced business on March 11, 1935. But, immediately next year, the statute was amended so as to make the State control of the Bank legally defined and positive. One of the important planks of the Liberal Administration which was returned with a large majority in 1936 was the 'nationalization' of the ownership and control of the central Bank.<sup>2</sup> Complete 'nationalization', however, was not effected immediately but control of the State by direct participation in the capital and management of the Bank was <sup>introduced</sup> ~~introduced~~. New shares known as class B shares which were to be held by the Minister of Finance, were issued. The Minister, in consequence, was entitled to appoint six directors with approval of Governor-General-in-Council. The new directors were given two votes each. These new directors along with the two Governors could secure a substantial majority for the government in the Board of Directors. Immediately after two years, this state control of the ownership and management of the Bank was made complete. In 1938, the private holders of class A shares were bought out at 59 dollars 20 cents for each share of 50 dollars. All the directors

1. A.E.W. Pluntre. Central Banking in British Dominions. Toronto 1940, p.188.

2. Ibid p.147.

were to be appointed <sup>by</sup> the Government.

The same reaction to the accepted view of the status of central banks was displayed in New Zealand after the establishment of the Reserve Bank of New Zealand on conservative lines in 1934. By the Amendment Act of April, 1936 the Bank was transformed into a government institution. The statement of objectives given in section 10 of the Amendment Act is significant as regards the role of the Bank under State direction. It reads : "It shall be the general function of the Reserve Bank within the limits of its powers, to give effect as far as may be to the monetary policy of government as communicated to it from time to time by the Minister of Finance, for this purpose, and to the end that the economic and social welfare of New Zealand ~~and~~ may be promoted and maintained, the Bank shall regulate and control credit and currency in New Zealand." <sup>1</sup>

The same attitude towards the status of the central banks is visible in countries which came to be dominated by totalitarian economic planning ~~and~~ during the inter-war period. A glaring example of such countries is supplied by Hitlerite Germany. The ~~Reichsbank~~ Reichsbank of Germany before the Law of 1924 was privately owned but it was operated by the government. The Law of 1924, however, broke this old association of government control and created the new Bank as a privately-owned joint-stock company controlled by its own Board of Directors.<sup>2</sup> But this independent body could remain as a controlling power of currency, credit and discount policies, upto March, 1933. The Bank was placed under legally defined control of the State by a Law of June, 15, 1939. It was subjected to the unrestricted sovereignty of the Reich and was to serve "the aims set up by the National Socialist State, especially the safeguarding of German currency." This was not all. The Bank was made an

1. Fed. Res. Bull., June 1936 p.413.

2. M.B. Northrop. 'Control Policies of the Reichsbank 1938, p.29.

integral part of the dictatorial machine. "The Reichsbank", it was provided, "shall be responsible directly to the Fuhrer and Chancellor of the ~~minh~~ Reich". The Bank was to be directed and administered by the president of the Reichsbank and a managing board in accordance with the instructions from the Fuhrer and the Chancellor of the Reich under his supervision. The Fuhrer was also to determine the appointment and term of office of the president and other members of the managing board. It is strange that the capital of the Bank could be held by German citizens. However, they were not to be personally responsible for the liabilities of the Reichsbank.<sup>1</sup>

In Italy, the Law of March, 1936 transformed the Bank of Italy in a public institution and provided for repayment to private shareholders of the old capital and part of the reserves of the Bank. The new capital of 300 million lire was not put up by the State but was subscribed to by savings banks. In Denmark, the National Bank of Copenhagen was transformed into a State central bank on 1st May, 1936. The capital was ~~for~~ directly purchased by the State. So far as the government control of management was concerned, the measures adopted in Denmark were less radical than in the case of previously noted countries. The government secured a substantial representation by appointing its nominees along with other members of the Board of Directors which were to be drawn from varied fields of economic activities in the country.<sup>2</sup>

TOWARDS NATIONALIZATION: The Bank of England.

This trend towards increasing State control of central banks reached its culmination in the post-war period. The change that was

1. Fed. Res. Bull., September 1939, pp. 737-738.

2. Money and Banking 36/37. League of Nations Vol. I p. 82.

gradually coming over, adapting itself to the new requirements, became drastic and revolutionary especially when the old Lady of Thread-needle Street, which supplied, right from its inception, a theoretical foundation for the central bank independence, was nationalized in 1946.

The stock of the Bank was transferred to a person nominated by the Treasury on whose behalf the stock of the Bank was to ~~the~~ be held by him. So far as the system of management was concerned, the old set-up was retained. The old officers, such as the Governor, Deputy Governor and Directors in the first instance vacated their offices. But <sup>these</sup> officers were newly appointed by His Majesty. The status of the Bank Executives is not absolutely subordinated, for, according to the new arrangements, though the Treasury is empowered to give directions to the Bank from time to time, such directions are to be given only after consultation with the Governor of the Bank and which may be thought necessary by this authority in the public interest. Subject to any such directions, the affairs of the Bank are to <sup>be</sup> managed by the Court of Directors.<sup>1</sup>

The French Act of Nationalization of banking is a comprehensive measure containing many innovations as regards the methods of credit control and the organizational set up. By the law of December 2, 1945, not only that the Bank of France was nationalized but State ownership and State supervision of other commercial banks also was introduced. The Bank of France was nationalized from 1st January, 1946. The final control of credit is vested not in the Treasury as in the case of U.K. but in a body known as the National Credit Council, specially created for the purpose. The National Credit Council is to work under the presidency of a minister appointed by the government with the Governor of the Bank of France as its

1. Fed. Res. Bull., May 1946, p. 480.

vice-president. In addition to these two officers, the Council consists of other 38 members drawn from varied fields of the country's principal economic activities.

The National Credit Council has to propose to the Minister of Finance the allotment of available funds to be reserved for the needs of the Treasury and for the capital issues intended for metropolitan France, the overseas territories and foreign countries. The Council should be consulted by the Minister of National Economy regarding general credit policy with a view especially to the financing of the plan for the modernisation of national economy and of import and export projects.<sup>1</sup> The Council is empowered to obtain from the banks, private as well as nationalized, detailed reports on the composition of their portfolios along with the names of the borrowers ~~as banking~~ and the amount of their borrowings. Nationalization of banking in France is the direct consequence of the financial needs of the Treasury, rather than a desire to control credit for public interest. Heavy reliance of the Treasury on the Bank of France was the only way to fill the gap left by inadequate tax receipts and savings. The Bank of France had to purchase abundantly from the Treasury its short-term obligations so much so that the limit to such loan had to be raised from 100 billion francs to 200 billion in 1947.<sup>2</sup>

In the Royal Decree of October 1, 1945, reinstating the Netherlands Bank Act which was suspended during the war, the same tone of the ultimate superiority of government is evident. Article seven of the Decree reads: "Whenever our Minister of Finance deems it necessary to co-ordinate the monetary and financial policy of

1 Ibid. p. 487

2. Margaret G. Myers - "The Nationalization of Banks in France". Political Science Quarterly, June 1949, p. 201.

3. Fed. Res. Bull., May 1946, p. 489.

government and the policy of the Netherlands Bank, our Minister shall issue to the Management of the Netherlands Bank the regulations needed for achieving that purpose. The Netherlands Bank shall be obliged to observe these regulations? <sup>2</sup> 1

The post-war attempts at bringing the central banks under the legal and direct control of government appears to be the continuation and enhancement of the trend that had long since begun. Viewing thus, the post-war measures may seem to be mere formalization of the relationship between the State and central banks. Thus, in the case of the Bank of England, during the inter-war period, there is found a close cooperation between the Bank and government. Immediately after the First World War, the monetary policy was determined by the Bank and the government in such a close co-operation that it was impossible for any layman to discover the degree of responsibility that they were ~~individually~~ individually bearing. <sup>32</sup>

The position of the Bank of England was indisputably independent of any form of legal control as it was categorically pointed out by the Macmillan Committee. The Bank was characterised by the Committee as 'unique' as a central bank, in that it was a private institution independent of legal control save in regard to its powers of issuing bank notes and granting loans to the State. <sup>3</sup>

But in practice this sort of freedom was given altogether a different meaning by the Bank authorities. In 1936 Mr. Montague Norman, the famous Governor of the Bank, made clear the practical meaning of the legal independence and how it was to <sup>be</sup> exercised. Thus the Governor stated, 'We wish to use this freedom in the only proper way it can

1. Fed. Res. Bull., May 1946, p. 489.

2. H. Clay, the Post-war Unemployment problem p. 59.

3. ~~Economist~~ Macmillan Committee Report 1931, London, p. 25 para 80.

be used and that is in harmony with government's policy. I assure the Ministers that if they make known to us <sup>through</sup> appropriate channels what they wish us to do in the furtherance of their policies, they will, at all times, find us willing with good will and loyalty to do ~~what~~ <sup>what</sup> they direct us, as though we were under legal compulsion". The same authority a year later stated : " We must look largely to the Chancellor of the Exchequer and we assure him that in all matters his requests govern the conduct of our affairs. We would prefer, however, that he made his 'requests' as such rather than in the form of legislation. Legislation is too foreign a method".<sup>1</sup>

According to the new law by which the Bank of England was nationalized only a statutory recognition is given to the custom and ~~tradition~~ tradition that have developed through history. The measure, as generally observed by critics, does ~~not~~ not alter the original impression that the nationalised Bank of 1946 will not differ in any fundamental way from the privately owned Bank of 1945 or, for that matter, of the past decade.<sup>2</sup> It has been made clear that there will not be any interference with the day to day working of the Bank. Even in the case of the new practice of publishing annual reports and giving maximum information consistent with public interest, the government would be guided by the views of the Bank itself. As a close co-operation between the Bank of England and the government was already existing before nationalization, it may be said that the new measure hardly introduced a change for practical purposes.

But such a cooperation cannot be assured every where and for all times. A semi-government institution, though not explicitly differing with the government, may thwart the attempts of government

1. Quoted. Money and Banking 1937-1938 Vol. I League of Nations Footnote. 14 p. 83.

2. The Economist. Feb. 16, 1946, p. 250 & 259.

economic stabilization by underground dealings. Such a fear was, actually realised especially when the various governments were struggling hard to relieve the distress of the depression of Nineteen Thirties. In the case of Australia, it was stated by the Australian Treasurer that the Commonwealth Bank and private banks refused to assist the rehabilitation plans of the Commonwealth and State Governments which were designed to relieve acute unemployment and restore industrial activity amidst deep-seated depression.<sup>1</sup>

When a popular government undertakes the task of economic planning, the policy followed in various fields should be unanimous and aimed at the common economic end. Conflicts of opinion, howsoever honest they may be, should be avoided. Even in England where the Bank of England whole-heartedly co-operated with the government, the functions that the Bank was performing were so important and vital that it would lead any one to say that it was the Bank of England rather than the government that was in actual control of the amount of the national income, the external value of the pound-sterling and the standard of living of the people in general.<sup>2</sup> This factual position was mysteriously shrouded so long as harmonious relations were maintained. Such a smooth relationship would largely depend upon the attitude and broadness of imagination that would be displayed by those <sup>who were</sup> at the helm of affairs in the two camps. It may be that a Governor of the Bank narrowly interpreting the law, may insist upon the legal rights of the Bank and thus may create a serious situation for the government. Such critical junctures are not absent in the recent history of the Bank of England. Lord Cunliffe was at times insistent upon his legal position

1. Speech delivered by the Treasurer in the House of Representatives quoted by M.A. Kriz in 'Central Banks and the State today'. Am. Eco. Rev. September 1948, p. 572.

2. Amber Blanco White. 'The Nationalization of Banking' London, 1934 p. 26.



as the Governor of the Bank of England. Thus, on one occasion during the First World War when the government was in urgent need of funds for payments in New York, Lord Cunliffe failed to provide the necessary funds and insisted upon leaving such matters to him. The Secretary of the Treasury, Mr. MacKenna, had to take drastic action but for which, it was believed, there would have been irretrievable damage to British prestige.<sup>1</sup> Another example of conflict between the government and financial interests led by the Bank of England is supplied by the situation in 1930-31. When the Labour Government of the time asked for an American loan, the U.S. required the British Government to balance the budget especially by exercising a drastic cut on unemployment benefits as a pre-condition for the ~~budget but the~~ loan. The Labour Cabinet were ready to balance the budget but in their own way and not as dictated by the U.S. Though this sort of dictation seemingly came from the U.S., it was the British bankers and financiers along with the Bank of England who were active behind the American advice. The Labour Government ultimately had to go out of office on this point of conflict.<sup>2</sup> The Socialist Government in British Britain in the post-war period cannot contemplate such conflicts.

The nationalization of the Bank at the time it has taken place may appear to be only a symbolic attempt to respect a party doctrine. Nevertheless, in the future ~~of~~ the significance of the measure may assume different form. This would depend upon the extent and the way in which various governments will make use of the powers conferred upon them by the Act. But even if we view it purely in the context of the time of the measure, it cannot be said to be introducing a fundamental and basic change. This would be evident from clause 4(3) of the Act which aims at the control of commercial

1. ~~Amherst~~ Lord Beaverbrook: 'Politicians and the War', 1914-16, 1928 pp. 161-5.

2. G.D.H. Cole. Economic Tracts for the times, 1932, pp. 21 & 52.

banking. This particular provision marks a fundamental and important change. The clause reads thus:

"The Bank, if they think it necessary in the public interest, may request information from and make recommendations to bankers and may, if so authorised by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any request or recommendations".

It is not possible to ascertain from this the exact nature of the 'information' that would be requested for and the 'recommendations' that would be made to bankers. Such information must have been certainly secured by the Bank in the past. Requests from the Bank have <sup>never</sup> been lightly ignored in the City. In this respect, the clause may be said to formalize the state of affairs that already existed. But the informations asked for and recommendations made by the Bank in the past might not be the same as and may even fundamentally differ from those that may be insisted upon in future under clause 4(3). In the past the directions of the Bank might be based merely on unwritten conventions which were long accepted by the bankers themselves and thus, there could not be any opposition by the bankers to the directives of the Bank. For, the opposition would involve a danger to the whole credit structure of the country and this might have adverse effects on the position of banks themselves. Again, central banking control directed towards the control of the volume of money in general interferes less with the individual independence of a commercial bank, for, it is not discriminatory. Raising or lowering of Bank rate or influencing bank reserves by means of open market operations & does not raise objections from banks. But the control intended under clause 4(3) is certainly not similar to that exercised by the Bank in the past. This is because the future economic policy of the government which brought about this measure will be

radically different from that in the past.<sup>1</sup> The purpose and nature of the future control of banking system being different, it cannot be successfully exercised on the lines established by conventions. Though the Act is silent about this, it can be very easily gathered from speeches occasionally made by the Chancellor of Exchequer with reference to the reform. The following words of the Chancellor in the Labour Government which promulgated the Act of 1946 are of immense significance in this respect:

"It is essential that we should be able in the last resort, to establish priorities in the ~~the~~ disposal of short-term funds in the same manner as we shall in a later measure, assure priorities of national interest in regard to long term credit".

And further:

"It may be desirable in certain circumstances to urge the banks to devote their resources to one or other form of investment, which, it was felt by the Government and the Bank, was necessary in the interest of a planned priority with a view to securing full employment in the country and building up our export trade and other necessary elements in our economy".<sup>2</sup>

What the Chancellor sought to secure by this is a comprehensive instrument to achieve the economic ends referred to above by him. Money is such an instrument. It is a servant

1. The drastic nature of the directional control of bank funds that is implied in clause 4(3) is being gradually revealed in recent times. In December, 1951, the Chancellor of Exchequer addressed a special letter to bankers asking them to direct their funds towards the mobilization of exports especially to dollar areas. For this, the banks were required to subject all applications for loans to close scrutiny. These applications were to be either 'permitted' or 'restricted' or totally 'declined' according to the directive given to the banks. Such directives from the authorities cause a great lot of embarrassment to the relations between the banks and their customers, which was quite rare during the time of war. Customers on the other hand find it difficult to understand why their propositions should fall without the 'permitted' category and should be turned down when they are sound & desirable from the point of view of their own business. Matters

2. Quoted in Economist, Feb. 16, 1946 p. 260. (Contd. on page 214)

whose services require to be completely requisitioned in order to secure the desired objectives. It cannot be allowed to serve two masters at a time, for, its divided loyalty would do more harm than good. Clause 4(3) in the Act of nationalization of the Bank of England attempts to realize in practice what Keynes recommended as an important measure of State policy in his General Theory. According to him, a somewhat comprehensive socialization of investment would prove the only means of securing an approximation to full employment.<sup>1</sup> Socialization of investment is impossible without the State control of bank funds. Social control of short-term investible funds may not be the only means of securing full employment but it is the most important means which, if utilized properly, will prove of considerable help in furthering the aims of the government.

Clause 4(3) aims at directional control of bank funds. This sort of control is generally foreign to the British central banking traditions. The moral power of the Bank to influence commercial banks, as distinct from its quantitative control of the volume of bank credit, has always been very sparingly used in England. Only very rarely indeed, if at all, the Bank's opinion of what ought to be done has been backed by any hint of pressure.<sup>2</sup> The objective of directional control of bank credit being given, it is difficult to ascertain how far the Bank of England as a privately owned institution would have helped the government

(Note 1 contd. from page 213 )

are especially aggravated when, according to a fresh directive, banks are compelled to withdraw facilities that were quite unobjectionable previously. (Banker's Magazine. 'Treasury Intervention in Bank Lending', Sept., 1953 pp. 213-214).

1. Keynes . General Theory, p. 328.

2. Economist . Op.Cit., Feb., 16, 1946 p. 260.

in realizing its objective. Even if a whole-hearted co-operation and support from the Bank is assured, it is doubtful whether the banks would have yielded to the Bank's directives or 'requests' and 'recommendations' without the force of law behind them. In the past, it is true that ~~as~~ the Bank of England was a technical instrument in carrying out the monetary policy of the government and the Bank's policy was also the policy of the government. Despite this fact, the whole ~~tradition~~ tradition of the Bank of England was that of a great City institution belonging to the world of high finance rather than to the government. The Bank was ever proud of its independence vis-a-vis the State. Its relations with the government were those of a treaty rather than of ~~unhappy~~ subordination.<sup>1</sup>

The Old Lady would be scrupulous not to adopt measures that would offend the City bankers, (i.e. London bankers). In case of conflict, the influence of the City may weigh more with it than the considerations of government economic policy. Nationalization of the Bank of England, therefore, ~~must~~ implies much more than merely 'to bring the capital and stock of the Bank of England into public ownership'. The government in Britain had certain economic objectives in hand and necessary instruments for the realization of these objectives must be with in the control of government. As the Chancellor himself stated, 'the measure of nationalization was to ensure a smooth and efficient growth of the financial and banking system of Britain to meet the needs of the future'. The Economist has significantly interpreted that the 'future' meant by the Chancellor is 'socialist future'.<sup>2</sup>

#### RESERVE BANK OF INDIA.

Nationalization of the Reserve Bank of India is in keeping

1. G.D.H.Cole. Money: Its Present and Future. II Edn. 1945, p. 193.

2. Economist. Feb., 16, 1946 p. 260.

not only with the post-war trend towards State control and State ownership of central banks but also with the change in the political status of the country. In the past, though the Bank was 'independent' in the sense that it was a share-holders' concern, it failed to serve the financial and credit needs of a backward agricultural economy. Its policy was directed towards helping the government in its objective of maintaining a high exchange value of the Rupee in terms of sterling. As it was conceived on old lines drawn from central banking traditions in England, the Reserve Bank had, no doubt, its own limitations. A large sector of the country's money market, namely, the unorganised sector, remained outside the purview of the Bank's control. The Bank was not much approached for accommodation even by the organised sector. This is borne out by the very low volumes of discounts and open market operations of the Bank in the pre-war period .<sup>1</sup>

During the Second World War, the Bank became a pliable instrument in the hands of the Government for inflationary financing of war. In the post-war period, the Bank as a share-holders' concern could no longer be relied upon to bear the responsibility of helping the economic development programme of the National Government. Right from its inception its control was gradually passing into fewer and fewer hands and there was all the likelihood that government might be thwarted in their programme of national economic reconstruction by a small community of economic interests. From the past elections to the Board of Directors one can easily learn that vested interests had firmly entrenched themselves in the affairs of the Bank. In actual practice the Directors not only

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1. K.N.Raj. Monetary Policy of the Reserve Bank of India.  
p.79 & p.106.

elected themselves but even their successors.<sup>1</sup> In view of the changed political status of the country and its ambitious economic objectives, the Reserve Bank of India, as it was constituted under the Act of 1934, would cause misgiving in the mind of any man as regards its ability and reliability for controlling the financial system of the country in the interests of economic development. It was, therefore, in the fitness of things that the Reserve Bank of India was nationalized.

The Reserve Bank of India became a nationalized central Bank from 1st. January, 1949 according to the Reserve Bank of India (Transfer to Public Ownership) Act, 1948. According to the official view, 'this Act was passed in order to implement the government policy that the Bank should function as a State-owned institution and to meet the general desire that the control of government over the Bank's activities should be extended to ensure a greater coordination of the monetary, economic, and financial policies'.<sup>2</sup> The general superintendence and direction of the affairs of the Bank are vested in a Central Board of Directors which consists of (i) the Governor and two Deputy Governors to be appointed by Union Government, (ii) four Directors to be nominated by the Union Government one from each of the four Local Boards, (iii) six Directors to be nominated by the Union Government and (iv) one government official to be nominated by the government.<sup>3</sup>

The Act which brought about a change in the status of the Reserve Bank of India does not introduce far reaching changes in the powers of the Bank so as to render it a strong instrument in the hands of the Government for monetary and financial control. This is subsequently done by the Banking Companies Act of 1949. Section 21 of this Act specially empowers the Reserve Bank to

1. Indian Finance. Sept., 1945 p. 377.

2. Report on Currency and Finance 1948-49. Reserve Bank of India, p. 144.

3. R.B. of India (Transfer to Public Ownership) Act, 1948, sec. 8(1).

exercise directional control on bank funds such as one conferred upon the Bank of England by Clause 4(3) of the Bank of England Act, 1946.

As regards its relations with the Government, the Reserve Bank of India is to remain independent in its day to day working. However, the Act empowers the Union Government to give from time to time such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in public interest. This provision is the Indian version of Clause 4(1) of the Bank of England Act. It is worthwhile to note here that the proviso "After consultation with the Governor of the Bank" in the two Acts, Indian and British, has not got the same significance. In the case of Britain, the Governor of the Bank of England is not an official belonging to the Civil Service. He holds his office by virtue of his special technical knowledge in the domain of national and international finance. He is, therefore, technically well equipped to advise the government as to what 'directions' are necessary in public interest. In the Indian context this proviso has practically no significance, for, the Governor belongs to the Civil Service and he may not be invariably associated with the world of finance before his appointment to the office of governorship.<sup>1</sup> Even the

1. The appointment of the present Governor of the Bank, Shri. N.R. Pillai, best illustrates this point. Shri. Pillai has been transferred from the Ministry of External Affairs, where he was Secretary-General to that Ministry. Even before this, he does not seem to have held any post which could bring him into close acquaintance with the problem of finance and banking. The appointment of Shri. K.G. Ambegaonkar as the Deputy Governor which was also made simultaneously with that of Shri. Pillai has got some consistency in that that he was Secretary to the Ministry of Finance just before his present office. (Times of India, November 24, 1954 p.1).



Dy. Governors are appointed from the Civil Service cadre not on account of their specialization by long association with the problems of monetary management but on account of their being qualified for the post ~~according~~ according to the rule of seniority. Consultation with the Governor of the Reserve Bank referred to in section 7(1) of the Act of 1948 would only be a formal consultation. This proviso seems to have been introduced only to imitate closely similar provision in clause 4(1) of the Bank of England Act, 1946.

### Nationalization in Practice.

The change that the new position of central banks would introduce in the management of money can be evidenced only when the governments begin to exercise the powers conferred upon them by law. Despite that, certain consequences are bound to follow. In the first place, it may be said that the Treasury will now no longer be able to camouflage its responsibility behind the facade of a privately owned central bank.<sup>1</sup> Theoretically, this may be true to a certain extent but in practice such a change does not bring any material advantage. For, since the days of the depression of the thirties, the governments and not the central banks have been held largely responsible for the economic miseries of the people. This does not require any separate responsibility for monetary measures. If investment is falling followed by falling employment, it cannot be stimulated by pursuing a cheap money policy alone. Several other measures over and above monetary ones have to be adopted. ~~Amidst~~ Amidst a comprehensive government policy for raising the level of employment, monetary policy alone cannot be assigned any individual responsibility. In such a case it is the government rather than the central bank upon whom the final responsibility for full employment ultimately rests. The

1. M.A.Kriz, Op.Cit., p.580.

theory of laissez-faire<sup>is</sup> long dead, the advantage of exposing the government policy that was uptill now concealed behind an 'independent' central bank lacks substance for practical purposes.

The second possible consequence is that the banks would be only intermediaries between depositors and borrowers. The skill they used to exercise in selecting the right type of borrowers will have to rust into obsolescence. The credit-worthiness of a borrower now would depend upon ~~the~~ not the approval of a banker but that of government. Such a state of affairs may not be at once undesirable. But at the same time it is not free from abuses. The credit-worthiness of a borrower according to government may not depend upon his financial stability, his past career, and the standard of productivity that he maintains. The requirements that the producer supplies for the national economic plan would be the guiding principle. The banker may be obliged in such a case to risk his funds and, if the government comes forward to hold all financial responsibility ultimately, it would be tantamount to an extravagant use of public money.

Such a situation was anticipated in the discussions preceding the Act of nationalization of banks in France and it was even actually realised after the Act. One nationalized ~~bank~~ gas and electric company applied for ~~an~~ a loan from one of the nationalized banks. The bank asked the company to supply with a financial statement giving informations about the company's affairs prior to 1945, which the company declined to submit. The Minister of Finance intervened and ruled that, since the loan was guaranteed by the government the bank had no ground for complaint. The amount of loans that the nationalized banks are thus pressed to make is believed to be considerable.<sup>1</sup>

It may be said that the banks have little to fear by this,

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1. Margaret Myers. 'Nationalization of banks in France', P.S.Q., June 1949, p.208.

for, even before the new measures the government was their largest borrower. With the preponderance of government securities in their portfolios, the banks have little to fear the depreciation in their assets so long as the government guarantees their prices as per present policy. To the already existing large volume of government securities, government-guaranteed securities would be added and, for that reason, the banks have no cause to fear losses. It is immaterial to the banks whether the borrower is a private individual or a public enterprise so long as the loans are creating sound assets in their portfolios. But if thus a very large part of bank money is absorbed in government or government-guaranteed securities, there is all the possibility that other businesses may have to starve even for their legitimate needs. In the case of France, there is evidence that the small business and especially small retailer outside Paris and other bigger places finds it more difficult to borrow from banks even for his legitimate needs.<sup>1</sup> A similar experience is gathered in Britain also. Small concerns particularly the private companies requiring additional finance, at times have found it difficult to secure accommodation at the banks. Such borrowers are obliged to resort to private non-bank companies who have taken to lending business at high rates. Propositions of customers, howsoever acceptable they may be to the banks, are turned down by them under the pressure of Treasury directives. Customers, on the other hand, have found it difficult to understand as to why their propositions should be declined when they are quite sound and desirable from the point of view of their own business.<sup>2</sup> To the extent that private business has to depend upon bank credit, difficulties for borrowing are bound to arise.

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1. Abid ,p.208.

2. Banker's Magazine, Op.Cit.,p.13 213.

The Forces making the Change Inevitable.

The trend towards increasing subordination of central banks to the Treasury, which ultimately culminated into nationalization, is a result of certain forces making the change in the status of central banks inevitable. The most important of these forces is the event of (1) the <sup>Great</sup> ~~Great~~ Depression with the consequent break-down of the international gold standard. So far as the quantity of money was governed by certain rules as those of the gold standard system, it was immaterial whether the Treasury or an independent central bank effected changes in the supply of money. It was all automatic and neither the Treasury nor the Central bank was incapable of acting otherwise than the course prescribed by the rules. But the disintegration of the international gold standard introduced much discretion in monetary management which cannot be undertaken without broad directives from the government. After the break down of the gold standard, the transactions of the purchase and sale of gold and foreign exchange became considerably risky. The central banks therefore, could not afford to assume these risks. Government intervention for the purpose of regulating the foreign exchange value of national currency was, therefore, indispensable. It is interesting to note that, though the central banks were empowered to carry out transactions in gold and foreign exchange through a special institution, namely, the Exchange Equalization Fund, the gains or losses resulting out of such transactions were to be on account of governments and not the central banks.<sup>1</sup>

(2) The second important development which increased the influence of the Treasury in monetary management is the enormous growth of public debt. In the post war-period, the Treasury in various countries came to assume direct responsibility for certain

1. R.G. Hawtrey. The Gold Standard in Theory and Practice, 5th Edn., 1948 pp. 151-52.

monetary measures for the purpose of managing the public debt. Not only that the Treasuries now form the vested interests in whose favour effective monetary action has to be sacrificed, but public debt management has more aspects of monetary management and exerts considerable influence on the quantity of money. As for example, the financing of budget-deficits through the banking system, increases the quantity of money, while sale of public debt obligations to non-banking public does not do so. The old relation between the quantity of money as controlled by the central Bank and the price - level does not hold <sup>good</sup> today. On the contrary the changes in price-level can be comfortably traced to the changes in government expenditure. These developments have automatically lowered the prestige and importance of central banks as the managers of the quantity of money in public eyes. The instruments of management have been long since atrophied due to the government insistence on cheap money firstly as a measure to help economic recovery and afterwards to keep the burden of interests costs on public debt as low as possible.

- (3) Thirdly, in the post-war period international monetary co-operation has taken place at the initiative of governments wherein central banks appear as agents and instruments of their respective governments.<sup>1</sup> The co-operation of central banks with their governments in the circumstances has to be ensured by their 'nationalization' ~~them~~ so that they may form an integral part of the public machinery of economic regulation in the field of national as well as international affairs. It is really strange to note that the very purpose for which a nationalized central bank is considered to be essential in the post-war period, was expected to be served better by independent central banks free from political interference

1. J.M.Keynes. Speech before the House of Lords, May 23, 1944 reproduced in November Economica Ed.S.E.Harris, London 1952 p.373.

in the inter-war period. Co-operation of central banks was pleaded on many grounds, the main among which were to increase the number of countries on gold basis,<sup>1</sup> and to provide a well co-ordinated international monetary system.<sup>1</sup> The organization which, as a result, came into existence, namely, the Bank of International Settlements, was a body composed of central banks of various countries, as the members rather than their respective governments.

#### The Change and the Problem.

The complete subordination of central banks to government by law and reducing them to an executive branch of government leaves the old controversy unresolved. The change does not necessarily guarantee monetary policy decisions independent of political influences. What is essentially needed is the judgment and representation of monetary aspects of the economic policy of government before the people. The very 'independence' of the central bank was responsible for defeating this particular objective of monetary policy, for, a privately owned body could little inspire respect for its views amongst the people at large. Truly speaking, being not a public institution, it could not claim a public hearing for its views as the other government departments were able to do. The Treasury, being a government department, every day coming into close contact with those who are ultimately responsible for the economic policy of the country, could at once get its views accepted. If the central bank is to play an effective role in the formation of monetary-fiscal policy, outside opposition and objections will be of no avail. It should act through the government. Acting through government does not necessarily imply subordination to government. The case for a separate central banking agency can be simply made by saying that it can contribute a view-point in government monetary-fiscal policy formation that is specifically <sup>oriented</sup> ~~exacted~~ towards the maintenance of

1. Paul Einsig. The Bank of International Settlements- London 1932, p.24.

an over-all economic and financial stability. Only a separate agency can be counted on to advance strongly the case for monetary restraint when it is needed. A central bank that has to act according to the directions of the Treasury, though it may be consulted before such directives are given, can little hope to prevail against the needs of large scale fiscal operations.

What is needed is an equal hearing for the Treasury and central banking points of view in the determination of economic policy. A separate central bank can play an effective role, only if its status is roughly equal to that of the Treasury in government monetary-fiscal counsels. Its job should be to argue the case for monetary restraint when it is needed regardless of the narrower debt management considerations, or to argue for monetary expansion where that is required for mitigating instability.<sup>1</sup>

Given the equality of status between the Treasury and the central bank, monetary management should be viewed as neither the responsibility of the central bank nor that of the Treasury. The government as a whole should be answerable for the monetary consequences of its policy. In this respect, a co-ordination between the monetary and fiscal policies of government should be brought about in order to secure an effective management of money. The object of this co-ordination is to manage the quantity of money which includes not only cash and bank deposits but also liquid assets. Such co-ordination of fiscal and monetary policies will at once reveal the conflicting effects of the two policies carried on through two separate and uncoordinated agencies. This is evident from the experience in the post-war period. Thus, in France, in the post war period drastic monetary measures were adopted to control inflation. The reserve ratio composed of cash, bank balances and

1. G.L.Bach. 'Monetary Policy formation'. Am.Eco.Rev., Dec., 1949 p. 1188.

Treasury obligations to be maintained by banks against demand liabilities was raised as high as 95%. Despite such a drastic monetary action, inflation was progressive indicating the failure of monetary controls. This was because there was a conflict between the monetary and fiscal policies. The effects of monetary policy were counteracted and neutralized by those of large-scale borrowing and deficit financing by the Treasury.<sup>1</sup> When government undertakes deficit financing on a large scale especially by borrowing from the banking system, restrictive monetary policies such as raising of reserve requirements or dear money policy have no effect on the quantity of money. An experience similar to that of France can be cited in the case of Britain also. In Britain, at the end of 1952, due to dear money policy, it was thought that advances and hence the deposits of the Clearing Banks would fall. Advances declined no doubt, but the deposits did not show any decline. For, despite dear money policy, government spending financed out of borrowing from the banking system continued. The whole blame for not checking inflation here goes to government fiscal operations rather than to monetary policy. In this respect the best course is to prescribe ~~to~~ a limit to the amount of credit that the government can raise from the banking system as is done in Germany.<sup>2</sup>

The experience of inflation control both in France and England indicates that inflation control should not be the exclusive concern of monetary policy but of both fiscal and monetary policies working in co-operation. No nation can hope to realize the objectives of controlling inflation by controlling only the quantity of money, when the government is increasing purchasing power in the hands of the people by deficit financing. In such a situation, fiscal and

1. M. Myers. Op. Cit., p. 206.

2. The English Banks and Government borrowing! C/O The Journal of Credit and Finance Vol. IV No. 1/2 Apr 1953, p. 26. (Published from Frankfurt, Germany).



and monetary policies are at rivalry, and if both the objectives of inflation control and deficit spending are to be realized, use of physical controls becomes indispensable.

The Problem of Authority in Monetary Management.

The problem of authority in monetary management is the problem as to who should determine the ends of monetary policy and also its corollary as to by what means the ends may be secured. One of the important advantages of the international gold standard was that it provided both ends and means of monetary management at a time. The objective of external stability was to be secured and this could be done by regulating the quantity of money so as to correspond with the gold reserves. Both the ends and means being given, the management of money was at once simple, easily understandable and it did not allow any ~~the~~ tinkering by those responsible for it. So long as, therefore, both ends and means are not fixed, the old problem remains. Monetary management in the hands of government as against an independent central bank does not solve the problem. It does not give any guarantee against a tinkering with money causing jeopardy to public interests.

The ends of monetary management, however, are determined in broad terms such as 'internal stability' 'full employment' prevention of 'undue use of credit for speculative purposes' etc. Thus, in the case of Federal Reserve System the ~~member~~ member banks are prohibited from extending credit to be used 'unduly' for the speculative 'carrying of or trading in securities, real estate or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions'. The Federal Reserve Board is authorised to change reserve requirements for member banks 'in order to prevent injurious credit expansion ~~or contraction~~ contraction. Open market operations are to be undertaken by the Board 'with a

view to accommodating commerce and industry'. The objectives of Federal Reserve Policy thus defined leave a great deal of discretion-ary authority with the Federal Reserve Board. The Board is not given a clear cut <sup>guiding</sup> guiding principle to secure the objectives thus stated. It is difficult for the monetary authority whether under the direct control of the Government or otherwise, to determine as to when credit expansion begins to be 'injurious' or what exact amount of credit should be necessary to accommodate commerce and industry or when credit for speculation would become 'undue'. Not only that the people will not be able to understand the implications of a monetary measure but the monetary authority itself will not be able to perceive the course of its action. When the objectives of monetary <sup>policy</sup> policy are not precisely defined, the monetary authority has no clear-cut guiding principle to be observed. To use an analogy, the monetary authority in such a case is only given a good craft but not a tested chart and a dependable compass without which, even if the pilots <sup>are</sup> being clever, it is difficult to perceive hidden rocks and reefs that lie in wait on every hand. Such is the excitement of the time when economic activity is rising by leaps and bounds, that no one is ready to believe, before the coming of a crash, that existing activity is anything but wholesome. It would seem that even the passengers on the craft along with the pilots may not lack in excitement.

In monetary management, therefore, it is not the authority but rules that should matter. It is true that the simple rules such as those of the gold standard are an impossibility in the present context. In spite of that, the national legislature can be entrusted with the task of prescribing rules to be observed by the monetary authority. Once the rules are defined by a competent

1. Joseph E. Goodbar, 'Managing People's Money.' 1938, p. 342.

legislature, the monetary authority, whether a State-owned central bank or an independent one, loses its importance. For, the the monetary authority cannot become discretionary or dictatorial quite arbitrarily. (As soon as definite rules are established, the people will be able to judge a monetary action by comparing it with the basis supplied by the rules. They would be enabled to exercise adequate moral pressure if there is a departure from the standard supplied by the rules.<sup>1</sup>

It is true that in the present~~e~~ state of complicated financial structures, it is very difficult to find out an adequate rule or set of rules which can be safely relied upon. Despite that, some definite principles to be observed in monetary policy can prove of great help. This is well illustrated by <sup>the</sup> policy followed in England after its going off the gold standard. In England, after its going off the gold standard, the objective of the monetary policy was to maintain as steadily as possible the internal purchasing ~~the~~ power of the pound. This objective was achieved by the steadiness of the volume of bank deposits and the quantity of money in general. The policy proved successful and the results it yielded were far happier than elsewhere especially in the U.S. However, in the present situation, a relatively stable quantity of money can hardly achieve stable prices. Nevertheless, an appropriate quantity of money is the essential basis for a price policy. The quantity of money, as pointed out earlier in this chapter, will not only include cash and bank deposits but also liquid assets. ~~The~~ To control these constituents of the quantity of money, monetary measures adopted by the monetary authority alone will not suffice. The use of fiscal policy for this purpose will have also to be made. An appropriate quantity of money becomes the joint responsibility of the government acting through the twin agencies of the Treasury and the central bank. } 1. H.C.Simons. Rules vs. Authority in Monetary Policy. Readings in Monetary Theory. A.E.A. 1951, p. 367.

At present one comes across a great deal of talks about 'full employment, budget' and 'full employment fiscal policy' but the monetary implications of such a policy are given little importance. In the whole policy of economic stabilization, the most relevant question that remains unanswered is that at what price level the economic stabilization should take place. This problem of an appropriate price level assumes a special importance in the post-war period characterised by the existence of a huge burden of public debt in all the countries. An extraordinary burden of public debt introduces an inflationary bias in monetary policies. This is well borne out by the policies followed both after the First World War and the Second one.<sup>1</sup> It is essential, therefore, that, as fiscal measures of government are placed before a critical and competent legislature every year, the programme for the monetary policy of government should also be placed annually before the same responsible body. The national legislature, along with giving its approval to the fiscal measures of the government, would also give approval, after due examination, to monetary measures proposed by the government. The most important monetary objective to be recommended by the legislature would be as regards the price level. There cannot be a fixed level of prices which can be ideally suited to a full employment economy. It is appropriate, therefore, that a range may be given by the legislature ~~within~~ within which fluctuations may be allowed. ~~It~~ Once this ~~range~~ range is fixed, the scheme here proposed will bear a close resemblance to the gold standard system. For, under the gold standard also the quantity of money was managed so as to allow fluctuations in prices within the range of the gold points. Not only that but the proposed system will have certain advantages over that of the gold standard. Firstly, unlike the gold standard system, the range that should be fixed for price

1. J.M. Keynes. A Tract on Monetary Reform! 1932 pp.63-65.

fluctuations will be subject to annual examination and revision if necessary. Secondly, the range fixed will be larger than that under the gold standard and, therefore, would make adjustments smoother and less catastrophic. So far, <sup>as</sup> the domain of purely monetary measures is concerned, the monetary authority will try to abide by the rule with the help of all the instruments of monetary management and also directional control of credit. In an integrated monetary - fiscal framework, the fiscal policy will also be exercised within the limits set by the rule of the price-level. The test of the success of the monetary and fiscal policies directed towards the objectives of full employment will not be the securing of full employment alone but also the attainment of that at a price level within the limits prescribed before. Full employment conditions accompanied by inflation aggravate the very distress which it is the objective of full employment policy to alleviate. Not only that inflation will take away much of the comfort and <sup>happiness of a</sup> ~~another~~ large number of those already employed but even those who would seem immediately to benefit from the policy will gain very little in substance. In the post-war period there were full employment conditions in the U.S. but there was also the problem of rising prices. The policy of the raising of the rate-structure by the Federal Reserve Authorities in order to check inflation was opposed by the Treasury. One of the important reasons for the opposition to the policy of raising the rates was, as cited by the Treasury, that such a measure would adversely affect employment situation ! In order to make the benefits of full employment real, prices should be checked from rising for, after full employment any rise in prices is inflationary in the Keynesian sense and inflation is indefensible under any pretext.

The determination of the price level rule by a legislative body, no doubt, will not completely remove the possibility of tinkering with monetary policy but it would considerably reduce

its scope. The distinct advantage, that would result out of the system here proposed, is that it would arouse popular interest in monetary problems. Monetary problems and the knowledge thereto will no longer be the monopoly of <sup>a</sup> the few experts. It is said that an independent central bank makes for a lazy cabinet.<sup>1</sup> It can similarly be said that monetary policy determined by few specialists even under the direct control and supervision of government makes for an ignorant and, therefore, easily tractable legislature, so far as monetary policy is concerned. It is essential in the interest of a democratic control of economic policy that the legislature may be able to understand ~~with~~ what the specialists are saying to it and to judge it in the light of its wider, even if shallower, knowledge.

It may be that in the beginning the fixing of the span of price fluctuations may involve some elements of arbitrariness but by experience it would be possible to reach a suitably workable range. When the objective ~~the~~ of maintaining the prices is given, the government shall have to make conscious efforts to realise that objective. Failure in its realisation will provide an occasion for the public to probe into the policies of government either in the monetary or fiscal field or in both.

The policy of achieving increasing employment and output by ever rising prices defeats the very purpose for which output is increased. For, when the rise in prices ceases to be accompanied by rise in real income of consumers, consumption tends to fall. It is necessary, therefore, that discretionary elements in the management of money should be reduced as far as possible. Without this the depredations of extravagant governments and the interests active behind them will pilfer a large part of the real income of society by the most surreptitious instrument, namely, inflation.

1. A.B.White, Op.Cit.,p.29.