

Chapter X

THE PLACE OF MONETARY MANAGEMENT IN THE PROGRAMME
FOR ECONOMIC STABILIZATION.

Monetary management is essentially the quantitative management of money. Changes in the quantity of money are brought about by means of changing bank reserves. The changes in the quantity of money ~~and~~ thus brought about, influence the rate of interest, and the changes in the latter are expected to control the economic activity in general. The various instruments of central banking policy such as the rediscount rate, open market operations and changes in reserve requirements are based on the ~~same~~ same logic.

The regulation of economic activity by means of monetary policy rests on the changes in the cost of credit or the rate of interest. Few people would ~~it~~ now deny that monetary policy aimed at influencing the cost of credit has lost all its effectiveness especially since ~~monetary has lost all its effectiveness~~ on the events of the thirties. It has been now clearly recognized that other non-monetary factors affect prices and business activity so powerfully that they cannot be controlled by monetary action alone.¹

The Availability Vs. The Cost of Credit.

Several reasons are pointed out for the failure of monetary policy during the Great Depression. Two reasons among these stand out as most important and general. Firstly, monetary policy does not and cannot influence directly the most important cause of depression, namely, the deficiency of demand. This is because the expansion of the quantity of money followed by the lowering of the cost of

1. F.R.B. 'Objectives of Monetary Policy' Sept., 1937 p. 328.

borrowing does not result directly into spendable incomes. So long as spendable incomes do not rise the most important cause of depression, namely the deficient demand, cannot be removed.

Secondly, the central bank policy of cheaper money does not reach immediately all the areas in the structure of interest rates. It touches significantly only the short-term rates and gilt-edged long term rates. The flooding of the banking system with excess reserves can bring down the rates of interest in a limited number of areas such as government security market and short-term loan market. But these rates are not important for encouraging long-term private investment. It may be expected that the effects of low rates on short-term loans and government securities will soon spill over to other rates of interest. But this generally does not happen. This is because, in the first place, the banker's estimate of risk involved in various investments differs from borrower to borrower. Cheap money policy, therefore, does not bear the same significance for all the borrowers. In the second place, deficient organisation in backward countries like India. In India the of market considerably dilutes the effects of cheap money especially effects of low rates do not pass beyond the frontiers of organised money market which is composed chiefly of commercial banks. The result is that the advantages of cheaper credit are not available to the agricultural sector of the economy. Even in countries with organised money markets, small borrowers in country centres are not able to avail of cheaper credit. In the U.S. in 1938, about one fifth of all member-banks received on the average more than 7 per cent. on their loans and the proportion must be larger for non-member banks.¹ Thus, for the general run of intermediate and small scale enterprises, for more risky ventures and for small cities

1. ~~See Handbook of Banking and Business Statistics 1940~~ F.R.B. March 1940 p.197.

and communities, cheap money in the banking system offers no adequate remedy. For these areas fantastically high excess reserves and a high degree of bank liquidity are apparently of little avail.¹

The limitations of cheap money policy arising out of the banker's calculations of the element of risk involved in different investments and deficient organisation for the distribution of credit were well ~~recognized for the distribution of credit~~ recognised during the Great Depression. In order to make cheaper credit available to a large number of borrowers, the existing distributional system was supplemented by special types of financial and credit institutions in several countries. Thus, in the U.S. certain loans by private banks are now guaranteed by special institutions such as the Federal Housing Administration, Federal Farm Mortgage Corporation, Federal Land Banks, Export and Import Bank and Reconstruction Finance Corporation. During the Depression these agencies rescued the institutional lenders like the banks, insurance companies and investment trusts from the welter of bad debts. Not only this, but they also made funds directly available to borrowers who could not become ~~eligible~~ eligible for loans from banks and other investors. The Federal Housing Administration by guaranteeing loans on residential construction, encouraged banks insurance companies etc. to enter a field, where, without such guarantee, they would not venture without demanding rates so high as to ~~preclude~~ preclude willingness to borrow.²

In order to make cheap money policy really effective, central banking policy designed to supply ~~at~~ funds at low cost needs to be supplemented by special agencies raised to serve the specialized needs of different classes of borrowers. In future,

1. A. H. Hansen. 'Fiscal Policy and Business Cycle' 1941, p. 81.

2. Ibid p. 82.

therefore, monetary policy can be used as an effective instrument for reviving business activity by directing it to the problem of availability of credit, rather than to the cost of credit alone. The special agencies raised for this purpose should be the regular constituents of the market for loanable funds. In the post-war period, the need for such special institutions cannot be over-emphasised in the case of a backward country like India. This aspect of the management of money seems to have received a good attention in India too. We have now special lending agencies such as the Industrial Finance Corporation, State Financial Corporations, Land Mortgage Banks etc.

The problem of availability of credit may be tackled in the post-war period not simply by raising special financial institutions. The monetary authority may exercise direct control over the direction of bank credit. This has been largely made possible by the nationalization of central banks and the powers given to the nationalized central banks and to their Governments under the Nationalization Acts. Thus, in Britain, the banks can be directly compelled to use their resources for one or other form of investment as required by the government and the Bank of England. In France, the banker cannot question the credit worthiness of a borrower if the government guarantees the loan to the borrower.¹ Such a control of directing the resources of banks to the channels deemed desirable by the government leaves very little room for the banker's freedom to select the right type of borrowers according to his own calculations of risk. He will, therefore not be able to charge a higher rate of interest to the borrowers who ordinarily do not become acceptable to him.

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1. See Ch. Relations between the State and Central Bank, p. 220

Monetary Policy and the Levels of
Income & Employment.

As regards the first limitation of monetary policy namely its incapability to create spendable incomes, it should be accepted without any reservation. There is nothing ~~in~~ in the central banking policy of influencing bank reserves that can bring about the creation of new income and employment. Income depends upon expenditure on consumption goods and production goods (i.e. investment). Monetary policy can help the formation of new incomes by encouraging investment by lowering the cost of borrowing or the rate of interest. But investment in modern capitalist societies does not depend upon the rate of interest alone. There are several other factors which influence investment more powerfully than the rate of interest can do. All of these factors can be subsumed under marginal efficiency of capital or expectations of profits. The most important prop of marginal efficiency of capital is the effective demand for consumption goods or propensity to consume. The policy of lowering the rate of interest cannot increase propensity to consume for it depends not upon the rate of interest but upon the level of income.

It may be argued that the policy of encouraging investment by lowering the rate of interest will bring about a rise in incomes. And increased incomes will make increased consumption possible. This may be true to a certain extent. But so long as the fundamental causes of deficient demand in modern individualist societies are not removed, consumption expenditure cannot be stabilized at a higher level. The discrepancy between the volume of the production of consumers' goods and the volume of current consumption will reappear after some time. When this happens, the levels of incomes and employment will again begin to sink down. The policy of rectifying this situation by increasing only the investment outlay either on private or on government account, therefore, begins at

a wrong end.

The policy of raising the levels of income and employment by means of encouraging especially investment is based on the tacit assumption that propensity to consume will take care of itself once the process of creating new incomes has been started by new investment outlay. This position is taken especially by Keynes. He contends that a net increase in investment even if it may be a small proportion of the national income, is capable of bringing about a far greater increase in employment and income. This is because an initial increase in ~~investment~~ income brought about by an increase in investment raised consumption outlay of those who become the first beneficiaries of increased investment expenditure. As these receivers of new incomes will spend, at least a substantial part of their incomes on consumers' goods, they would help to create further incomes for the suppliers of these goods. In this way each one of the subsequent income receivers will contribute to the incomes and employment of others by spending at least a part of their income on consumption. This is his famous Theory of Multiplier.¹ (The capacity of an initial net increase in investment to bring about a several fold increase in income and employment will depend upon the marginal propensity to consume. Keynes has recognised (G.T.p.118) the importance of consumption expenditure vis-a-vis investment. But, elsewhere, he attaches only a secondary importance to marginal propensity to consume, by taking it for granted that the propensity to consume 'is a fairly stable function'.² As the marginal propensity to consume is assumed to be a constant factor, the effects of the increment of investment on income and employment would be direct and immediate. According to Keynes, there is a special reason to assume the consumption function to be relatively stable. He

1. General Theory ch.10.

2. Ibid p.96.

states : "The fundamental psychological law upon which we are entitled to depend ~~upon~~ with great confidence both 'a priori' from our knowledge of human nature and from the detailed facts of experience is that men are disposed as a rule and on the average, to increase their consumption as their income increases; but not by as much as the increase in their incomes!"¹

So long as the assumption of stable consumption function holds good in actual practice, a small amount of net initial investment outlay will certainly bring about a several-fold rise in income and employment. But the assumption of stable consumption function may not hold good in actual practice. Firstly, the total propensity to consume of society as a whole would largely depend upon the distribution of income. If a large part of the new income that is created by the initial dose of investment, passes on to the wealthier classes the marginal propensity to consume will shrink soon and will dilute the effects of new investment on income and employment. Again, income which becomes available as profits of large corporations is not generally available for consumption.² If a substantial part of this income is retained as reserves, the total flow of consumption expenditure will shrink causing a reduction in the new incomes to be ~~substantially~~ subsequently earned out of this expenditure. Therefore, though, it is necessary to stabilize investment at a high level for the purpose of stabilizing income and employment, such a policy should not be carried on at a level of inadequate consumption and by ^{leaving} ~~leaving~~ private investment to pursue an erratic course.

Monetary policy cannot influence successfully one of the most important factors upon which income and employment depend, namely

1. General Theory p.96.

2. G.Haberler. Prosperity and Depression, U.N.1946 p.229.

consumption expenditure. It may be argued that by easing the terms of instalment credit the purchases of durable consumers goods can be raised substantially. But in a depression, such a policy will prove a failure. For, demand ~~and~~ for consumers' durable goods depends upon especially the level of income while terms of instalment credit are of only secondary consideration. The total consumption outlay of the community can be influenced not by monetary policy but by fiscal policy based on redistributive taxation and expenditure on social security services by the State.

The Rate of Interest, Fiscal Policy & the Quantity of Money.

In spite of all these considerations, the monetary authority will have to decide upon a certain interest rate policy in a depression. This policy will be essentially a cheap money policy in the sense that the rates of interest will be brought down or they would be checked from rising if they are already prevailing at a lower level. The cheap money policy will be pursued not primarily for encouraging private investment but for lowering the cost of government borrowing. In a period of depression the government fiscal policy will have to provide an important link between the interest rate and quantity of money on one hand and the levels of income and employment on the other. In fact at any time the significance of the changes in the volume of money and the rate of interest consists in the influence that these changes exercise over the volume of income and employment. So long as the changes in the quantity of money exercised a direct and broadly proportionate influence on the level of income, it was natural to trace the importance of monetary changes which appeared to be both strategic and controllable.¹ Changes in the quantity of money could influence

1. H.H.Villard. Survey of contemporary Economies. Asia Publishing House, 1951 p.321.

income because private investment reacted favourably to the changes in the rate of interest. The private investment outlay provided a sort of a bridge through which the effects of the changes in the quantity of money were communicated to income and employment. Now, that private investment does not respond to the changes in the rate of interest so as to make the quantitative changes in the volume of money really effective for income and employment, its place has to be taken by government expenditure. Fiscal policy, therefore, has to intervene to make the quantity of money effective for raising the levels of income and employment.

During the period of depression the policy of lowering the rate of interest for the purpose of enabling the government to borrow at a lower rate, can be pursued ^{by} increasing the cash reserves of banks. As, in a depression, there is a dearth of assets which suit the bankers' considerations of safety and profitability, the increased liquidity of banks would compell them to lend to the government at a lower rate of interest. This ^{is} how monetary policy can help the government policy of increased expenditure for the purpose of stimulating income and employment.

Apart from a period of depression, government interest in the cheap money policy will be more or less of a permanent character. This is because a large volume of public debt will be a permanent feature of the capitalist economy. The idea of ~~such~~ chronic existence of public debt is based on especially three reasons. In the first place, private enterprise economy has a tendency towards a deflationary gap in the total amount of private outlay supporting income and employment. This gap ~~must~~ has to be filled in by government compensatory spending whenever and in whatever amount it occurs. It may be argued here that the government can repay its debt out of budgetary surpluses which would be realized in a period

of prosperity. But it should be noted that a comparatively long and continuous period of prosperity is itself an impossibility without public expenditure. For, maintaining a high level of income and employment government deficit spending more or less of a permanent character is indispensable. The indispensability of a permanent deficit financing is well borne out by the American experience in the later thirties. By the end of 1936, in the U.S., recovery was practically achieved. But this recovery at once gave way in 1937 to a new depression when, for a brief interval, budget came to be balanced. It is worthwhile to note that this balanced budget was secured not by a reduction in public expenditure but by a rise in the government revenue consequent upon the rise in national income.¹

In the second place, the deflationary gap may be the result not of a fall in the total outlay on private account, but of the gigantic productive power of advanced industrial economies. Technological progress has made possible an ever increasing volume of production which may surpass at any time the existing capacity of private and public outlay to absorb. This problem of over-production cannot be tackled by fiscal policy alone. For, in this case, the amount of deficit spending will have to be so large that it would be incompatible with a democratic individualist economy except in time of war.²

Superimposed upon these two reasons, there is the third factor which considerably enhances the possibility of permanent burden of public debt. This is the post-war heritage of huge public debt ^{created} ^{account} during the war. These developments point out to the fact that considerations of government debt policy will considerably

1. J.H.Williams 'Post-war Monetary Plans and other Essays' p.222.

2. J.M.Keynes quoted by J.H.Williams. Ibid p.229.
This problem of over-production is acute especially in mature economies as that of the U.S. In the case of under-developed systems like that of India the occasion of general over-production is far remote.

influence monetary policy. In a period of depression, this subordination of monetary policy to government debt policy does not raise any serious problem. But in a period of inflation the subordination of monetary policy to public debt policy would considerably enhance inflationary pressure. It is interesting, therefore, to examine the role of monetary policy as a weapon for controlling inflation.

Monetary Policy & the Control of Inflation.

The efficacy of monetary policy for the purpose of raising income and employment during a period of depression came to be seriously called in question after the experience of the thirties. But it was still considered to be a powerful weapon for controlling inflation. However in the post-war period, considerations of Government debt policy have created serious impediments to an effective use of monetary policy even for the purpose of controlling inflation.¹

The problem of inflation arises when the economy is functioning at a full employment or near full employment level. At this level of business activity, marginal efficiency of capital is generally higher and, as a result, there is a high pressure of private demand for bank loans. As the rate of interest carried by banks' loans, to private borrowers, becomes attractive to the bankers, they would be tempted to liquidate their holdings of government securities and use the proceeds of the ~~same~~ sales for advancing loans to private borrowers. The impact of this sort of behaviour of banks on the prices of government securities would be to force them down and, therefore, to raise the rate of interest on them. Here, the monetary authority, prompted by the considerations of government debt policy, will intervene to prevent the rise of the

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1. See ch. Public Debt, pp 153-156

rate of interest on government bonds. It would purchase at fixed prices whatever amount of government securities is offered to it. But such a policy would enhance the liquidity of the system at a time when there is an acute necessity to reduce it. Thus the considerations of government debt policy preclude the use of a restrictive monetary policy for checking inflation.

In order to prevent the rise in the cost of servicing the government debt or to enable the government to borrow at a lower cost in an inflationary period, it is sometimes suggested that monetary policy should not be used at all for the purpose of controlling inflation.¹ If monetary policy is not to be used, the policy of inflation control will have to depend upon other measures. One of such non-monetary measures is the use of direct controls which would help cheap money policy in an inflationary situation. This is true. After the experience in the post-war period, there is no doubt that cheap money policy in an inflationary context cannot be maintained without 'rigging the market' at several points.²

Here two types of controls may be proposed. Firstly, directional control of credit can do a great lot by checking bank credit from financing unnecessary investment or speculation. During the period of full employment great reliance shall have to be placed upon directional control of credit. Secondly, there may be instituted direct investment controls for curtailing private investment. This will be of special advantage when investment is too high and creates large excess capacities in a particular sector.³

Such measures as mentioned above will no doubt help the

1. ~~ibid~~ p. Ch. VII p.195

2. See ch. III p. 123

3. M. Kalecki. 'Economics of Full Employment', Oxford 1948 p.49.

objective of maintaining the rate of interest at a lower level. But even after admitting the need for direct controls in order to serve the purpose of maintaining cheap money policy in an inflationary context, one is tempted to ask: Will direct economic controls totally obviate the need for monetary action? If at all they are introduced with an intention of not using monetary policy at all, will they succeed in bringing about an all round reduction in inflationary pressure? In a period of high level of income accompanied by an over-liquid state of the economy, it is doubtful whether direct controls will prove effective for controlling inflation. For, under such ~~circumstances~~ circumstances there is a high pressure of demand for goods of all sorts. Consequently, excess demand controlled at one point breaks through at innumerable other points. In order to be effective, controls shall have to be stricter and all-comprehensive. Such a policy of controls, will prove incompatible with the private enterprise economies except in time of war. And even in time of an emergency such as that of war when the imposition of controls may be justified, administrative weaknesses and leagages considerably dilute their efficacy.

In the context of an all round inflation, controls alone cannot be relied upon as a sole weapon of regulating the economy. For, the effects of controls are ~~merely~~ peaceable and desultory. For, ~~the effects of monetary~~ securing an all round reduction in inflationary pressure rates of interest shall have to ^{be} raised, and supply of money shall have to be reduced or restricted. There is one characteristic of monetary policy which makes it transcend any policy of direct controls in point of effectiveness. Monetary policy is pervasive and hence its effect is felt throughout the economy. The raising of the rates of interest in several countries in 1950-51 has got this significance that it helped other government measures

that were aimed at the control of inflation.¹ It is true that monetary policy alone cannot help the control of inflation without seriously injuring the economy. But it is equally true that other measures of inflation control will also be ineffective without the help of monetary policy.

Government Deficit Financing and the Problem of Inflation Control.

As observed on page 312, the need for deficit financing and the chronic existence of a huge public debt prevent the use of monetary policy for controlling inflation. But in an inflationary context maintenance of an ultra cheap money policy in order to serve the needs of the Treasury is impossible without allowing the prices to rise. What is really to be decided here is not whether the rate of interest should be raised or not but that to what extent it should be raised. If the problem of the cost of government borrowing is to be given due consideration, rate of interest will have to be raised to a smaller extent, and monetary policy shall have to be supplemented by direct controls. Direct controls cannot obviate altogether the use of monetary policy but would help maintaining the rate of interest at comparatively lower level. Each one of these two weapons will be complementary to the other in the task of controlling inflation.

It is true that the raising of the rate of interest will raise the cost of government borrowing to some extent, nevertheless, such a policy will enable the government to successfully carry on its borrowing programme. The first condition that is necessary for enabling the government to borrow successfully from the market is the creation of sufficient liquidity in the market. This liquidity is provided by the open market purchases of the central bank. But so long as the rate of interest on government bonds is pegged

1. I.M.F. The Revival of Monetary Policy! Washington 1953.

at an artificially low level, the liquidity of the market is used for providing private loans rather than for purchasing government bonds. Government borrowing programme therefore fails despite there being sufficient loanable funds in the market.

This aspect of the relationship between the fiscal and monetary policies in an inflationary context is well illustrated by the post-war monetary situation prevailing in India. In order to provide cheaper finance for government development schemes the Reserve Bank of India pursued the policy of maintaining the pattern of interest rates by means of open market operations especially in 1948-49. The central banking authorities tried to check the flow of credit to other channels by issuing directives to commercial banks to regulate their loans and advances. But the events of devaluation of September, 1949 and the Korean hostilities of June, 1950 diverted the liquid resources of the system to finance speculative hoarding of commodities and inventory building. The consequence was that, though the open market operations were carried on to maintain cheap money rates so as to enable the government¹ to borrow funds from the market at fairly low rates, the government was unable to raise loans of the required amounts but speculators and hoarders derived full benefit from the prevailing low rates.

It is interesting to note that in the beginning the Government adopted all possible measures to meet the inflationary situation. While the interest rate policy was left untouched to meet the inflationary trends following the devaluations of the rupee in September, 1949, a comprehensive eight-point programme was announced in October, 1949. General measures were taken during 1950 to keep inflationary pressures in check and to hold the price line. After the outbreak of the Korean hostilities, the Central

1. The word 'government' stands for both the central and State Governments all combined.

Government assumed the power to legislate during the year, on trade and commerce and production, supply and distribution of goods—two of the subjects within the legislative competence of the States.

(Price controls on several commodities were reinstituted and drastic penalties were introduced to discourage hoarding of food grains.

(Control over investment was exercised through the control of capital issue and efforts were made to exercise some restraint over Government expenditure and to increase production.¹ These were heroic measures no doubt but what was conspicuous by its absence amongst all these measures was the use of monetary policy. Monetary policy was maintained status quo. The directives issued to the banks not to grant credit for speculative purposes were continued in force. In the absence of a proper interest rate policy, all other measures of inflation control could be of little avail. Bank credit continued to flow to speculative channels with the result that the busy season of 1950-51² witnessed a record expansion of bank-credit. The return of funds to banks in the following slack season was much smaller than the previous seasonal outgo.² Although there were other factors such as increase in production and greater imports occasioning increased bank-credit, speculative building of inventories and withholding of commodities from the market contributed to it substantially. The long-term yield on government securities indicated an upward trend, and there was a slight increase in the borrowing rates of Central and State Governments in 1950.³

(At last in November 1951 the authorities had to rise to the occasion.

(They realised that the stepping stone to ~~the expansion~~ ~~any~~ any programme of control of inflation is to reduce the liquidity of the

1. See Reply given by the Government of India to the questionnaire ~~ix~~ issued by the U.N. concerning Full Employment Standards, Economic Trends and Objectives and Domestic Economic Policies for 1950-51, reproduced in 'Problems of Unemployment and Inflation in 1950-51. U.N. 1951 p.133 163.
2. Reserve Bank of India. Report on Currency & Finance, 1951-52, p.51.
3. U.N. op.Cit., p.160.

system. So long as the system remains liquid other measures are ineffective. The liquidity of the system was reduced by raising the Bank rate from 3% to 3½% and especially by stopping the monetization of public debt by banks by means of a change in the policy of open market operations. A similar experience can be evidenced in Britain from the Daltonian experiment at cheap money policy in 1946-47, and from the post-war monetary policy in 1946-47 in the U.S.

The post-war experience in monetary management clearly indicates that, in order to control inflation, monetary factor shall have to be controlled. This control of the monetary factor will chiefly consist in the control of the quantity of money or the liquidity of the system. Directional control of credit in an inflationary situation is generally ineffective. This is because, though the banks may exercise all possible caution in selecting their borrowers, they cannot exercise vigilance as to the use ~~of~~ to which bank credit is placed by the borrowers. It is ~~a~~ just likely that the borrowers may shift their own working capital into speculation and replace it by means of bank credit which may be used ^{as} working capital. In such a case bank credit supports effectively, though indirectly, speculation. It is very difficult to know for the authorities as to in what way the borrower uses his funds. When there is the co-existence of the liquidity of the banking system and the demand for loans both for speculative hoarding of commodities and genuine trade purposes, mere directives to banks not to make advances to speculators cannot be of much help.

Government Deficit Financing & the Banking System.

In the present context as well as in the period to follow, management of money will be largely influenced by the considerations

of the management of public debt. The bearing on monetary management of the problems created by a large volume of public debt and the distribution of its ownership as between bank and non-bank holders has been already examined.¹ It is worthwhile to examine here certain false issues which have been raised as regards the impact of public debt on monetary policy.

(Firstly, there is the contention that the government should borrow as far as possible outside the banking system. This contention is based especially on two grounds. In the first place, it is argued that government borrowing from the banking system automatically increases the supply of money and, therefore, it has got inflationary effects. Another reason for not financing government deficits by borrowing from the banks is that the accumulation of government securities in the portfolios of banks makes quantitative management of money difficult.²

As regards the view that government borrowing from the banking system increases money supply it can be said that such an increase in the supply of money does not lead to inflation under all circumstances. Thus, in a period of depression government borrowing from the banking system, leaves the funds of the people free for their own use. If the government expenditure brings about a rise in the marginal efficiency of capital, holders of cash will use it for purchasing private investments. Again, in a period of depression the banks are in want of good earning assets which they can find only in government securities. Even if the government may be able to sell securities to non-bank borrowers in the beginning, there is no assurance that they will remain with them for a long period to come. For, in order to provide themselves with a good ~~quality~~

1. See Ch. Quantitative Management in General, p. 165-167

2. J.H. Williams. P.W.M. Plans & other Essays. p. 242 and p. 248.

quality of earning assets especially in a period of depression, the banks will repurchase the government securities from their original holders by slightly bidding up their prices. Whenever the banks find earning assets which suit their choice, they will get them by any means. An apt illustration of this sort of behaviour of banks is provided by the experience in the U.S. during the Second World War. During the war to hold down the volume of spending, public securities were pushed into the ownership of individuals and the banks were prohibited from owning these bonds. As the outlets for private investments were closed except in industries which directly or indirectly contributed to government war efforts, sufficient amount of good assets from private borrowers, were not available to the banks. They were, therefore, obliged to find outlets for their funds in government securities. When the banks were prohibited from owning certain types of bonds, they purchased them surreptitiously through their directors and officers by advancing loans to them. A large part of public debt, ~~through~~ though in the beginning sold to non-bank buyers, found a secure lodgement in the banking system in one way or the other.¹ During an emergency either that of war or depression, the Treasury cannot rely on private funds which may not forthcome in sufficient amount and at a proper time so as to meet the Treasury's requirements. Government, therefore, has to depend upon institutional investors like banks to a large extent in order to fulfil its borrowing programme.

It is certainly true that in a period of inflation such as it came to prevail in the war and post-war period the policy of borrowing from the non-bank public has got great utility. For, the purchasing power in the hands of the people can be mopped up by

1. 'American Banks and War Finance'. The Economist, April 23, 1944 p.539.

the government in this way, which would reduce the pressure of private demand for goods which are in short supply. But even here, it would be wrong to say that borrowing from the banks automatically gives rise to inflation. The factor which gives rise to inflationary pressure is the mounting government expenditure superimposed on the existing flow of private expenditure. Further, as regards the government borrowing from banks, the crucial fact is that the banks are enabled to purchase government bonds without reducing their existing investments and loans.¹ The banks are able to buy government assets because the monetary authority ~~repairs~~ replenishes bank reserves in order to ~~and~~ support the ever rising volume of bank deposits. Here, therefore, it is not the policy of borrowing from banks, but the monetary policy that is inflationary.

The problem of government deficit financing is not whether government should borrow from the banks or non-bank public but whether the government can borrow successfully the ~~and~~ necessary amount at a low rate of interest from the non-bank public. The problem for the Treasury is how to secure necessary funds at a comparatively lower rate of interest. Even if the Treasury may decide to finance the whole ^{of} the deficit in the budget from the subscriptions of non-bank public, it is doubtful whether it would be able to realize necessary funds at comparatively a lower rate of interest. In fact, banks help the Treasury in pursuing a cheap money policy for government deficit financing. As it has been pointed out in chapter first, monetary authority can counteract the liquidity preferences of the public by influencing the preferences of the banking system. When the holders of speculative balances are convinced that government can borrow at a lower rate of interest

1. Charles O. Hardy 'Fiscal Operations as instruments of Stabilization Readings in Monetary Theory. A .E.A. London 1952, p.427.

from the banking system, they will have to accept even a lower rate of interest for, otherwise, they will have to loose interest on their idle balances. They, therefore, have to fall in line with the banking system and have to accept a lower rate of interest, at which, but for the help of the banking system, they would not have come forth to subscribe to government loan. Borrowing from the banking system becomes indispensable in order to make cheap money policy successful. So long as the public is not prepared to invest on a sufficient scale in long-term loans to government at terms currently offered by the Treasury, the Treasury should borrow on short-term from the banking system. This would result in an expansion of bank deposits on which the public receives little or no interest and as this process continues, the terms offered on long-term loans may be expected to appear gradually more attractive to the public. In this way the investing public can be induced to lend to the government on longer terms at lower rates. Hence, the more the government borrows from the banking system by selling short-term debts to banks and so enlarging bank deposits, the better the term it can exact on long-term loans sold to the public.¹ This sort of cheap money technique has been used recently in Britain.

As regards the second reason that ~~has~~ is advanced against the policy of borrowing from the banking system, it should be stated that it is fallacious. So long as the policy ~~has~~ of stabilizing the prices of government bonds continues, an effective control of the quantity of money is impossible even if the whole of the public debt is held outside the banking system. Even if the banking system hold no government bonds, attempts to control the general credit situation, either by open market operations or changes in reserve ratios, would inevitably lead to unacceptable repercussions on the

1. W.M. Dacey 'The Cheap Money Technique' ~~In~~ Llyods Bank Rev. Jan 1947 p.51.

government bond market; in other words, the problem would be the same as it now is.¹ The quantitative ~~reserves~~ control of credit by means of changing bank reserves has been rendered ineffective not because of the concentration of government debt in the banking system but because of the policy of maintaining the prices of government bonds.

It is interesting to note that the problem of monetary management has become more difficult in the post-war period ~~not~~ because the banks are holding a large volume of public debt but because a large volume of it is held outside the banking system.² For, the central bank can stop the banks from monetizing public debt by prescribing ~~new~~ secondary reserves to be held in the form of government securities or can prescribe ever rising cash reserve ratio as the banks go on liquidating their government assets; but it cannot make individual holders of public debt amenable to such measures.

The second issue that is raised as regards public debt is that public debt management should be used as an instrument of economic policy.³ If the management of public debt is so devised that it can reinforce the contracyclical policies of government, it would no longer work as a clog in the government economic policy as it presently does. Public debt can be used as a contracyclical measure by inducing people to purchase government securities during the period of prosperity and to get them redeemed during a slump. This would help the authorities to mop up excess purchasing power in the hands of the people in a period of boom and supply purchasing power to the people in a slump. It is further believed that the

1. H.H. Villard. Survey of Contemporary Economics, 1951 p.345.

2. See Chap. VI.

3 H.C. Wallich. 'Debt Management as an Instrument of Economic Policy' A.E.R. June, 1946 pp.292-310

task of full employment policies will be easier due to the liquid assets holdings of the public. For, so long as the people possess liquid assets in the form of government securities, there cannot be any fear of deficient demand. Existence of public debt is calculated to impart greater cyclical stability and reduce the magnitude of cyclical fluctuations.¹

The view of using public debt as an instrument of economic stabilization is highly erroneous from several points of view. Firstly, it should be noted that during the period of prosperity any government will create debt only when it needs funds for government expenditure which is in excess of current revenues. In a period of prosperity government is not required to undertake extra-ordinary expenditure. On the contrary, in a period of ~~prosperity~~ prosperity budgetary surpluses can be easily realized. The policy of public borrowing simply for the purpose of absorbing excess purchasing power in the hands of the people in a boom is anything but rational. The present period is extraordinary because it inherits a huge volume of public debt and the governments are compelled to borrow for the purpose of refinancing the maturing debt which they are not able to redeem en masse. Not only that, but many governments ^{have} embarked upon mobilization programme for which they are required to spend huge sums which cannot be realized from tax revenue. But in ordinary times governments can better relieve inflationary pressure by reducing their expenditure rather than by borrowing from the people. By creating budgetary surpluses, government can advantageously undertake the redemption of public debt in a period of prosperity. Moreover, if the government follows the policy of borrowing in a period of prosperity in order to reduce

1. H.G. Johnson 'Secular changes in Bank assets' E.J. Mar. Dec. 1951 p. 556.

inflationary pressure, it would have to borrow at a comparatively higher rate of interest than the one at which public borrowing can be undertaken in a period of ~~any~~ depression. The policy of using public debt as a contracyclical weapon is a foolish policy which fattens the rentier at the cost of the tax-payer,

Secondly, in a period of depression the policy of redeeming government bonds can hardly be expected to bring about desired results. This is because a large bulk of public debt is generally owned by comparatively richer sections of the community whose consumption standards do not seriously fall during a slump. The standard of consumption increases with the rise in incomes. People would eat into their savings only when they are not able to meet out of their current income their expenditure on goods the demand for which is generally inelastic. The policy of debt redemption in a period of depression cannot be expected to restore the fall in private consumption expenditure caused by falling incomes. In a period of depression government needs some ~~xxx~~ positive programme of expenditure. The policy of debt redemption like that of tax remission does not give any assurance that it will give desirably spectacular results. What is necessary for counteracting economic fluctuations is a contracyclical fiscal policy. Government debt policy can be only a necessary adjunct of contracyclical deficit spending. There cannot be, therefore, any independent public debt policy specially designed for the purpose of economic stabilization.

Monetary Policy and Economic Stabilization.

After the events of the thirties of the present century, it has become evident beyond any doubt that monetary policy by itself is too weak an instrument to control cyclical fluctuations. But this does not imply that monetary policy has no significant role to play ~~any~~ in the general economic stabilization programme. Unfortunately,

the impression gathered during the years of the depression relegated monetary policy to a neglected corner in the general economic policy of government. But the experience of the post-war period has clearly indicated that the impression as to the efficacy of monetary policy formed during the special circumstances of the Great Depression cannot be true for all economic situations. Even during the depression monetary policy could have played a significant role had the policy been directed towards the problem of availability of credit rather than that of the cost of credit alone.

It is an undeniable fact that in a monetary economy no programme of economic stabilization can succeed unless it is based on an appropriate monetary policy. Monetary policy provides an effective starting point for the general policy of economic stabilization. This importance of monetary policy was no better ~~and~~ realised before than in the post-war period. Though monetary policy as the chief instrument of economic control has far deteriorated in importance, it has gathered greater importance in other direction in the post-war period. This new significance of monetary policy essentially springs forth from the fact that it provides a necessary framework within which other instruments of economic policy can successfully function. It is true that within the monetary framework the realization of the goal of economic policy will largely be the responsibility of fiscal policy aided by direct economic controls, nevertheless, the monetary framework will be important. As a modern writer has well placed it: 'Money may no longer be the master but, if it has become the servant, it is a servant without whose services the new masters cannot live and who, if not well treated, plays very nasty tricks on them. The position of money in the whole pattern of social and economic policy may not be completely dominant but it has remained pivotal'.¹

1. J.N. Beycn. Money in a Maelstrom. London 1951, p.154.

In the Great Depression monetary policy was asked to perform an impossible feat. It was asked to counteract single-handed the economic evils which were a joint product of a number of factors working in combination. Application of inappropriate remedies not only does not cure economic maladies but creates other unhealthy developments. It is of extreme importance, therefore, that monetary policy should be assigned a role which it can successfully play in a given set of circumstances.

The role of monetary management in an economic programme of government is to provide an appropriate monetary framework. An appropriate monetary framework does not necessarily mean an appropriate quantity of money. It means the degree of liquidity of the system suited to the policies of expansion or contraction. The liquidity of the system, in the first instance, depends upon the quantity of money and the quantity of liquid assets. It also depends upon distribution of the ownership of financial assets, especially public debt, as between the banking system and non-banking public. It is further conditioned by the maturity and other conditions attached to different financial assets. All these factors taken together give the liquidity pattern of the economy. The most important factor which influences the liquidity pattern of the community is the rate of interest. It is here that the rate of interest assumes a special significance in the financial system of a country.

As it has been well pointed out by Keynes, the rate of interest is significant in two respects; firstly, as mentioned ~~next~~ above, it has got a strong influence on the liquidity preferences of the people along with those of the banking system. Secondly, it influences investment by rising above or falling below the marginal efficiency of capital. In the latter case, other factors

governing the marginal ~~efficiency~~ efficiency of capital are so powerful that small changes in the rate of interest are not able to influence investment ~~is~~ significantly while bigger changes are not advisable due to their unhealthy repercussions in other directions. But the role of the rate of interest as a factor affecting the liquidity of the system has come to assume a greater importance in the post-war period. Small changes in the rate of interest significantly influence the behaviour of the holders of financial assets. The monetary authority can significantly influence the liquidity pattern of the system and hence the general monetary framework of the economy by changing the pattern of interest rates or by raising or lowering them without disturbing their pattern. This role of the rate of interest is well borne out by the experience of the post-war period in several countries. It should be noted here that a rise in interest rates, brought about by the monetary authority in order to reduce the liquidity of the system, is not incompatible with full employment ~~such~~ as is sometimes supposed. On the contrary, such a measure is likely to help full employment policies of government. In the post-war period an undue fear was entertained by the monetary authorities as regards the adverse effects of the policy of raising the rate of structure, upon ~~which~~ the employment situation. This is well borne out by the experience in France. In France, the stricter credit policy pursued during the period of 1948-50, compelled the traders to release surplus stocks. This helped the authorities in eliminating shortages of goods at home. There was an increase in industrial production by 10% while unemployment remained at a low level.¹

In order to influence the liquidity pattern of the system, the

1. Twentieth Report of the Bank of International Settlements p.220

monetary authority may make use of selective credit controls in place of or in addition to the use of the rate of interest. In the case of public debt, the monetary authority can influence the distribution of the ownership of government securities by attaching special conditions to such assets. This is the role which can be assigned to monetary management. It is to regulate the liquidity of the system so as to prepare monetary conditions favourable for an economic policy.~~xxx~~

It may be argued that, as monetary conditions serve only as a back ground, monetary policy cannot play a leading role in the anticyclical programme as fiscal policy does. This contention is correct. Monetary policy has not proved an effective contra-cyclical weapon. In this respect fiscal policy enjoys a ~~hegemony~~ hegemony over all other contra-cyclical weapons. But it should be noted that the objective of governments economic policy is not simply the restoration of full employment but also the maintenance of full employment after it has been secured at an appropriate price level. The objective of a motorist, to take an analogy, is not only that of starting the car and driving it at a certain speed, but also to keep the car just on the track. Once the car has been started and imparted the desired speed, it is the steering wheel that is important and not the propeller or the accelerator. The function of monetary policy in the policy of maintaining full employment can be likened to that of the steering wheel. The main problem of the policy of maintaining full employment is how to avoid inflation. One of the outstanding economic phenomena of recent years is that unemployment and inflation have gone hand in hand. The most important factor which contributed to this unhealthy development was the failure of the authorities to lower the degree of liquidity of the system. When the economy is working under the

conditions of full employment, the task of monetary authority is to counteract inflationary or deflationary tendencies by appropriate changes in the quantity of money or by reducing or increasing the liquidity of the system. This role of monetary policy is well borne out by the monetary policies of recent years in different countries. Fiscal policy by its very nature is not suited for this purpose. For, changes in public expenditure or in tax rates cannot be effected all at once. If inflationary tendencies develop, constructions of government projects cannot be left incomplete so as to finish them later on when deflationary tendencies begin to reappear. Again, to stem back deflationary tendencies, new projects cannot be started immediately in the wake of such tendencies.¹ Fiscal policy lacks the flexibility which characterises monetary policy as the best instrument to be used under such circumstances. The problem, here, is not that of combating a developed depression or an inflationary boom. A great deal of confusion has been caused as regards the importance of monetary management by not distinguishing its role as a contra-cyclical weapon from that as an instrument to counteract inflationary or deflationary tendencies under the conditions of full employment.

Full Employment and the Problem of Inflation.

Monetary policy, as observed before, can be used for counter-acting the tendencies towards inflation or deflation. But sometimes extravagant claims are made over monetary policy. Despite an open hearted confession on the part of a monetary authority that monetary policy cannot control prices², it is sometimes suggested that stability in the level of prices should be the objective of monetary

1. L.W.Mints 'Monetary Policy for a Competitive Society' 1950 New York, p.210.
2. F.R.D. Sept. 1937, p. 424

policy and that this objective is 'susceptible' of attainment by monetary measures'.¹ Stabilization of the level of prices is something which the monetary policy cannot secure singly-handed. It is true that monetary policy may be directed towards this end but if violent fluctuations from the desired level of prices occur, monetary policy shall have to be reinforced by other measures. It is one thing to say that the stabilization of the level of prices is a desirable economic objective, it is quite a different thing to say that it is susceptible of attainment by monetary measures.

However, in the context of full employment and near-full employment conditions, the objective of stabilization of prices deserves some consideration. The Keynesian conception of true inflation which takes place only after the level of full employment has been reached has done more harm than good.² This sort of definition of inflation has made monetary management under the conditions of full employment or near full employment to suffer from an inflationary bias no less than the monetary policy of the gold standard suffered from a deflationary bias. The phenomenon of inflation and unemployment existing side by side in the post-war period contradicts the Keynesian conception of inflation. Any rise in the level of prices which is not accompanied by an increase in employment should be considered as inflationary. Or, if the increase in employment is negligible in comparison with the rise in the level of prices, an inflationary tendency should be clearly recognized. Any rise in prices that is not conducive to a rise in employment should be avoided for, it positively weakens other factors which support employment at a level already attained. Such a rise in the price level adversely affects the propensity to

1. L.W. Nims, Op.Cit., p.126.

2. General Theory, p.303 also p.119.

consume the fall in which creates a deficiency of demand for the goods which stand comparatively at a lower level in the consumption schedule.

Increase in employment can no longer be brought about by means of an increase in the quantity of money when inflationary tendencies begin to appear. In such a juncture government shall have to direct its fiscal policy especially in depressed areas and remove other causes impeding the rise of employment by means of direct interference. Both monetary and fiscal policies will have to be reinforced by the use of direct economic controls for the purpose of curbing sectional price increases. Economic controls, therefore, must be regarded as an indispensable weapon of full employment policy. Unfortunately, though we rely upon them as a sole instrument ~~of controlling the economy during an emergency of war without any comparison, in a period of peace, the economic exigencies of which may be no less than those of war, we generally~~ fight shy of them. It is iterated and reiterated that the government policy to maintain full employment should be based on a proper coordination of fiscal and monetary policies and that the approach towards full employment should be more ~~more~~ impersonal and democratic. The use of direct controls over prices, wages, materials and other economic life should be avoided for they render the full employment policy essentially dictatorial in its approach.¹

It goes without saying that a proper coordination of fiscal and monetary policies will go a long way in counteracting cyclical fluctuations. But the stabilization of full employment at the level of maximum real income is something which cannot be attained by means of such policies alone at this stage of capitalist system.

1. E.A. Goldenweiser 'Douglas Committee Report, A.E. Rev. June, 1950 p.389.

At what stage of the cycle the intervention of direct controls would be necessary would depend upon the elasticity of the supply of factors of production. The greater the elasticity of the ^{supply of} factors of production the less dependence upon direct controls. If the supply of different factors becomes inelastic at different points of the cycle, the 'point of full employment' becomes meaningless. The criterion of distinction between beneficial expansion of credit and one that is fraught with the dangers of inflation should rest not with the point of full employment but with the inelasticity of the factors of production.¹ This does not imply that monetary and fiscal operations should come to a sudden stoppage, as soon as supply of the factors of production becomes inelastic but ^{it implies} that they should be reinforced by direct government intervention for the purpose of removing the clogs either in the process of recovery or in the stabilisation of full employment at maximum real income.

The intervention of the State by means of direct controls does not imply necessarily the supplanting of private enterprise. The objective of such intervention is to secure the advantages of a competitive society which have been rendered today devoid of any practical interest. A free play of individual initiative cannot solve the economic problems of the actual world.² Central controls are meant to help private initiative to play its role in such a way that it can serve the objective of full employment and maximum real income.

The State, therefore, shall have to play an every extensive role and not only by undertaking expenditure on a large scale whenever private initiative fails to support full employment outlay, but also by instituting certain direct economic controls. When once it is recognised that economic fluctuations are inherent in the capitalist system, only a conscious regulation of that system can secure stability. By a conscious regulation and planning alone can the capitalist system be transformed from an economy of 'scarcity' to an economy of abundance.

1. Ingham L.M. 'Investment and the cost of production.' A.E.R. Sept. 1936 p. 473.

2. J.M. Keynes General Theory p. 378.