

INTRODUCTION

Before the break-down of the gold standard, it was believed that conscious and deliberate management of money would serve as a strong instrument of economic regulation. But the experience of the nineteenth century clearly indicated that cheap money policy was not a panacea for economic instability. However, that period is unique in the history of theory and practice of monetary management because of the revolutionary changes that took place in both of them. The present work is an attempt, in the first instance, to examine critically the new developments in the management of money. The monetary experience gathered during the thirties was one-sided in the sense that it pertained only to anti-deflationary monetary policy as required by the peculiar circumstances of the period. The post-war period¹, in this respect has to make some striking revelations as regards the role of money policy in an inflationary context. In the next instance, therefore, it is the purpose of this study to present a critical analysis of the post-war monetary experience.

The policy of stabilizing the yields on government securities, which was a dominating feature of the post-war monetary policy, has very interesting and instructive lessons to bear for the theory of monetary management. When the monetary authority stands ready to convert non-money assets into money at a fixed price, the difference between money and other assets is entirely lost. Quantity of money, under such a policy, has no dimensions. It is rather strange that Lord Keynes in *General Theory*, after pointing out the essential nature of money as most liquid of all assets, recommended dealing both ways in

1. 'Post-war period' as used in the following pages refers to the period following the Second World War unless otherwise stated.

debts of different maturities, as the most important practical improvement in the technique of monetary management. Such a policy recommendation runs counter to his whole liquidity-preference theory of the rate of interest. For, when interest-bearing assets are rendered almost as liquid as money by the policy of dealing in debts of various maturities, people earn interest not essentially by parting with liquidity as Keynes holds but by retaining liquidity ! The nature of money, the essential difference between money and other assets, the nature of the rate of interest and its determination are issues most germane to the theory of monetary management. I have started, therefore, with the discussions of these issues in the first chapter.

The removal of the gold standard removed a great hurdle in the way of cheap money policy. The cheap money policy poses a two-fold problem. In the first place, it is to be decided how a fall in the rate of interest influences entrepreneurial decisions in general and those in different fields of investment in particular. In the second place there is the problem as to how long-term rate of interest can be brought down and maintained at a lower level. A policy of cheaper money cannot be realized except by an increase in the quantity of money. Management of the quantity of money, therefore, occupies a pivotal position in the theory of monetary management. This problem of cheap money policy forms the subject matter of chapters second, third and fourth.

In the post-war period an effective control of the quantity of money has been rendered impracticable by the considerations of government debt policy. Public debt represents a single factor dominating monetary policy in the post-war period. The issues raised by the government debt policy have been discussed in chapters fifth and sixth and to a certain extent in chapter tenth. Here and also elsewhere I have selected especially the American experience for the purpose of

illustration because the problem for monetary management raised by public debt was most serious in that country and also because the Federal Reserve System is considered to be a sort of laboratory for monetary experiments. Certain innovations in central banking control were first introduced in the U.S. and have by now developed into accepted instruments of such control there rather than elsewhere.

The economic depression of the nineteen-thirties dealt a crushing blow to *laissez faire* and ushered in an era of increasing State intervention in the free working of the economic system. This trend towards increasing State control made inroads in the domain of monetary management also which culminated ultimately into nationalization of central banks in the post-war period. Nationalization of central banks, in my view, does not provide an adequate solution of the problem of authority in the formation of monetary policy. For, when the monetary authority is vested in government, there arises the danger of utilizing monetary policy to subserve the needs of the Treasury. This is well borne out by the post-war experience in many countries. It is my plea, therefore, that monetary implications of government policy, whether fiscal or monetary, should be placed before a competent legislature and should be scrutinized by that body in the wider good of society.

Chapters eight and nine deal with the theory of managing the external value of money. An issue of great theoretical as well as practical interest here is that of *modus operandi* of the process of adjustment in the balance of payments under different conditions. It is surprising to note that the theory of the gold standard dominated policy for a long period despite there being a wide difference between its theoretical assumptions and the actual forces which worked up to adjustment. The policy of devaluation which followed in the foot steps of the discarded gold standard suffered from the same short-coming inasmuch as it was based on the assumption of price-effects on exports

and imports. It was not until Keynes's General Theory was out that the forces of relative income movements rather than price movements could be recognised well as the agents of adjustment in the balance of payments. This indicates that expansion of world trade rests primarily on the expansion of incomes at home and abroad and it can be secured only by means of international economic co-operation, by understanding the difficulties facing individual countries and by international good will. The International Monetary Fund and other international organisations are the steps towards securing this objective. However, in my view, balance of payments disequilibria will be frequently removed in the post-war period neither by price adjustments nor by the adjustment of the rate of exchange, as it was the practice in the past, but mostly by direct controls. It is here that the I.M.F. will be called upon to play its role of fostering a co-operative spirit among the member nations so that they may not adopt beggar-my-neighbour policies which they can well afford to give up without jeopardizing their national economies.

The facile opinion formed during the thirties that monetary policy was only a weak and, therefore, unreliable instrument for raising the level of employment, made it to play only a second fiddle to fiscal policy. The task of monetary policy was only to maintain the rates of interest at a lower level. Beyond this, economic stabilization was the responsibility of fiscal policy. This notion about the role of monetary policy was the outcome of a limited experience of the thirties. It had to be given up in the light of the post-war experience. It is true that problem of economic instability cannot be solved by monetary manipulations alone, but I believe that monetary policy can make a distinct contribution to the policy of economic stabilization in general. Economic regulation, according to my view is the joint responsibility of three instruments, namely, monetary policy, fiscal policy and direct controls. Amongst these, monetary

policy occupies in no way an inferior position to the other two. This position of monetary policy in the general economic stabilization programme of the government is clearly pointed out in the last chapter. The function of monetary policy is to maintain a proper monetary framework by regulating the quantity of 'money' or, properly speaking, the quantity of 'liquidity'.

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