CHAPTER I

THE MONETARY ROLE IN ECONOMIC DEVELOPMENT

Real versus Monetary Factors

Economic development implies raising the standard of living of a country through an increase in productive capacity. The issue is that of a more optimal utilisation of the existing factors of production. The magnitudes involved are real, and the obstacles present are also real. The optimal utilisation of resources is hampered because all the cooperating factors are not present simultaneously. The factor mainly lacking is capital, not so much in the sense of money as in the sense of machinery and equipment. The volume of capital is low because total real income is low. All these are real difficulties and do not admit of any easy monetary solution. So monetary factors are usually neglected in plans for economic development. Once a policy is framed regarding real output, it is believed that monetary policy will automatically adjust itself.

MONETARY POLICY AS AN INSTRUMENT OF ECONOMIC GROWTH

There are many difficulties in the adoption of monetary policy as an instrument of economic growth even in advanced countries.
The difficulties are greater in an under-developed one. In developed economies monetary and banking institutions are becoming a relatively declining part of the whole financial mechanism. This development lowers the effectiveness of monetary policy as an instrument of growth or stability. In undeveloped economies, on the other hand, money is used relatively to a very small extent, not because the financial institutions are developed, but because they are underdeveloped. Monetary inducements to expansion would be limited there just for this reason, if not for others. The role of the monetary factor is further circumscribed by the fact that the banking system is not the only director of the flow of capital and credit. There are many agencies outside the organised banking sector through which the bulk of the capital and credit passes.

The hindrance to productive investment in an under-developed economy comes not only from the side of supply of capital. It is exercised by the demand side as well. What is also needed is an impulse to development. There is a lack of that creative type of entrepreneurship which is to generate productive investments. Its absence is to be explained by many factors, such as, lack of basic utilities, an atmosphere
of uncertainty, dearth of certain strategic factors of production. This creative entrepreneurship cannot be generated by money and credit. The initiative in economic development must come largely from governmental sources.

Prof. Whittlesay has pointed out that one of the difficulties of economic growth as an objective of monetary policy is that this target is more indefinite than others. Economic development is a rather vague and constantly moving target. (1)

The biggest drawback of economic development through monetary policy is that such policy must be expansionary in character. There is every chance that such an expansion will be accompanied by inflation.

**Inflation and Economic Growth**

One may examine, in this connection, the claim made by certain economists that inflation will lead to economic growth.

---

It is argued that a mild dose of inflation will release resources from some uses and make possible their employment in others.

Actually, inflation has very disastrous effects upon development. In an industrialised society the problem of growth is often that of unutilised productive capacity. There is sufficient technical potential to be put into use through the stimulus of an expanded monetary demand. But the problem of underdeveloped countries is not that of creating a monetary demand, specially in countries like India where economic development is largely a matter of state enterprise. The final effects of inflationary investment here are likely to be socially inequitable, and, if the inflationary practice is continued, self-defeating. For the resulting redistribution of the national income, together with the price-wage spiral which sooner or later is likely to be generated, will tend to transform the pattern of economic activity into one that makes less productive use of national resources, and perhaps ultimately to bring about an unwillingness to invest in industry and a reversion to speculative transaction in land and inventories, in which the economic history of underdeveloped countries with inflationary conditions abounds. (1)

Economic development is a long-drawn process spread over several years. The practicability or desirability of continuing an inflationary situation for such a length of time is doubtful. Apart from the social inequities and miseries involved, it would be unpracticable in a democratic country.

Inflation is sometimes described as "forced saving". Actually, inflation is a strong deterrent to saving. When prices go up, the value of savings in money terms is deflated. So people hoard commodities, gold or precious metals, or else they purchase land and buildings. In an underdeveloped economy, confidence in the medium of exchange is low even in normal times. This is bound to be still lower during an inflation.

Moreover, unless the administrative machinery and the system of physical controls are perfect (which is something very unlikely in an underdeveloped economy), it is not possible to predict before hand to which direction the price rise will be channelled, and when the object is to restrict consumption, the price rise is likely to be channelled to the direction where the need for consumption will be the highest.

Neither is a redistribution of income from the fixed income earning class to the variable income earners likely to lead to an increase in savings, as it is, in a mature economy. In an
6.

underdeveloped economy differences in income are already quite large, but still savings are low and it is very difficult to conduct them to productive sorts of investment. This sort of redistribution of income will also impinge hardest upon those whose level of consumption is already too low. It will lead to an increased pressure for consumption of luxury goods and thus to a further mal-distribution of real productive factors.

In a backward economy, the richer section comprises of the trading and landowning classes. A shift of income in favour of the variable income earners will create a further stimulus to these forms of investment, viz., trade and landowning. Even if there is some investment in the Secondary sector, it will move away to the production of consumption goods. In many underdeveloped countries, inflation generally leads to a build up of inventories. Thus in Chile, while prices rose more than ten times from 1950 to 1957 investment in fixed capital declined sharply over the same period. Again in Brazil, inflation was accompanied during 1950-54 by a more than six-fold increase in the flow of goods into stocks.

Thus the arguments put forth in favour of economic growth through inflation are largely illusory. The economic waste and social costs of inflation largely outweigh the gains achieved from an inflationary policy.
An attempt had been made in the monthly review of the Federal Reserve Bank of New York for August 1959 to establish a statistical relationship between economic growth and price stability or inflation. It had studied the case of sixteen underdeveloped countries. These countries belonged to two categories. First, those where prices had advanced moderately or not at all from 1950-57, including India, Burma, Ceylon, Cuba, Guatemala, Philippines, Ecuador, Honduras. To the other category belonged countries where sustained inflationary pressures developed during the period. These countries were Pakistan, Mexico, Argentina, Thailand, Turkey, Chile, Brazil, Bolivia. Statistical evidence pointed out that the former group experienced a more or less steady rate of economic expansion which was near an average of 6 per cent annually. On the other hand, countries where inflationary pressures persisted, showed widely varying and somewhat sporadic growth. The average rates of growth ranged from less than 1% to more than 7% with an average of about 4% for the whole group.

Chile represented a case of chronic inflation, reaching a stage of hyperinflation. During the three years from 1953 to 1956 the cost of living advanced nearly five-fold; at the same time, the output of goods and services not only stopped expanding, but actually declined. There was also a marked curtailment in productive investment. However, after the inflation had been brought under some degree of control in 1957, output once again began to expand. Similarly
in Bolivia, the near collapse of the price mechanism was accompanied by stagnation of production. In Argentina, Pakistan and Thailand, inflation was somewhat less extreme. Even in these countries mounting inflationary pressures had been accompanied by lagging output.

The only countries where vigorous rates of economic expansion were noticeable side by side with fairly intense inflationary pressures were Brazil, Turkey and Mexico. In Brazil this was achieved at the cost of a huge and mounting external debt. In Turkey also it was sustained by a huge inflow of external funds, mainly in the form of foreign aid. In both these countries, however, the pattern of economic growth was distorted and failed to be self-sustaining. Mexico was the only country where vigorous and well-balanced economic expansion accompanied a high degree of inflation. This was due to the presence of many favourable factors in Mexico, such as development of the public utilities, productivity of its agriculture, heavy foreign investments, a large internal market and a flourishing tourist industry.

On the other hand there were the countries where special monetary and fiscal methods had been adopted to bring about a balance between monetary demand and the available quantity of goods and services. Special mention should be made in this category of countries like Ecuador, Ceylon, the Philippines and India. The confidence in the stability of the currency had helped promote
voluntary savings, notably in India; it had induced a more rational investment pattern. It had also encouraged somewhat the growth of a broad capital market, particularly in India, Ceylon and Cuba.

A policy of reasonable price stability helps balanced economic growth in the following ways: first, it promotes rational programmes of development for the future, thus encouraging capital formation. Secondly, by fostering confidence in the currency, it stimulates growth of voluntary savings. Thirdly, it minimises social inequities.

The impact of inflation upon the balance of payments situation is particularly disturbing. It may have a severe restrictive effect upon exports which often constitute the mainstay of the economy. Inflation also gives rise to exchange rate instability and exchange depreciation, thus discouraging the inflow of private foreign investments.

Not only does inflation have harmful effects on savings and investment. Underdeveloped countries are particularly prone to inflation. The basic reason for the inflationary bias is that the investment effort regarded necessary to raise productive capacity to a desired level is far in excess of what is feasible on the basis of available savings. Inflationary potentialities also arise from the structural rigidities of the economic system. These comprise
10.

of the inelastic productive capacity, lack of basic utilities, inadequate distributive channels etc. Other contributory factors are the inelasticity of budgetary sources of revenue, political instability, administrative inefficiency, "demonstration - effect" of foreign standards of living, absence of the habit of saving and so on.

Case for Monetary Factors as Contributory to the Process of Growth.

The case for monetary policy as a causal factor in the process of growth seems to be very weak. There are two real obstacles to growth which cannot be eradicated by a manipulation of financial institutions. One is the low margin of savings over consumption. Secondly, even if some savings can be mobilised, there is little likelihood that all or the major portion of it will flow to productive enterprise rather than to primary or tertiary occupations. There are, however, grounds to believe that appropriate financial institutions do act as an aid to the process of growth. They can make a definite contribution to capital formation which would be retarded in their absence.

First, the monetary requirements will increase in a growing economy. There is a possibility that with economic development the monetised section will expand at the expense of the subsidised or non-monetised section. It is necessary that the latter be
brought under the purview of money and exchange in order that their surplus balances may be saved and not be hoarded in the form of jewellery or other commodities. These savings would be at the disposal of the authorities for capital formation. The significance of such savings in underdeveloped countries is apt to be underestimated. It is held to be an axiomatic truth that these are low output and low income countries, with a low level of savings and a very low rate of capital formation. Often, however, it is as much the shortage of total resources as the lack of creative entrepreneurship that impedes investment.

Wolf and Suffrin point to several evidences in support of this statement. They show that there are some savings in underdeveloped countries which are either lying idle or which take the form of such passive investments as residential construction, accumulation of gold and foreign exchange etc. The possibility of mobilising savings is further indicated by the accumulation of cash balances in governmental fiscal transactions in some countries, balance of payments surplus in others or by an outward flow of capital and private funds that are often accumulated in banks in foreign centres or else invested abroad in real estates or spent in luxuries, such as the large expenditures made on the continent by oil magnets of the Middle East. (1)

Not only are there untapped savings, savings may also be

generated, despite the low level of real incomes. Wolf and Saffrin quote an Indian National Sample Survey which indicates that over 7 per cent of rural expenditures, on an all India basis, are typically for ceremonial purposes, such as celebrations, marriages, births, funerals etc., with a regional figure as high as nearly 16 per cent in West India. An additional 6 per cent, as a national average, is spent on tobacco, intoxicants, refreshments and amusements. Marginal adjustments in this volume of expenditure might be possible if the demand for capital provided a sufficiently strong inducement to invest. Experience has shown that even in relatively poor areas, the marginal propensity to save tended sometimes to be surprisingly high, reaching about 60% in those cases where a strong local demand for capital existed.

It may safely be presumed that in an underdeveloped economy like India the problem of an insufficient demand for capital will be largely removed by governmental activity. The problem is how to adjust the available supply of capital to the demand forthcoming. It is necessary to set up proper financial institutions and to reorganise existing ones, so as to bring about a balance between demand for and supply of capital through them as far as possible.

Properly guided monetary and fiscal policies help not only in generating more savings, but also in changing the composition of investment towards the optimum. The need for an optimum allocation
of resources becomes all the greater with economic development, because development will lead to some increase in incomes, but in the early stages of capital formation the volume of consumption goods will not increase proportionately. The increased incomes will, therefore, exert an inflationary pressure upon the prices of consumption goods.

That the credit mechanism can play an important part in long run economic growth, has been emphasised by Schumpeter. (2) He has looked upon private credit as one of the indispensable accessories to entrepreneurship and innovation in a growing economy. Money is not merely a passive circulating medium, but it can actively insert itself within the circular flow of the economy. His argument is that economic development means a different employment of a system's productive powers. This can only be achieved by a disturbance in the relative purchasing powers. The entrepreneur cannot borrow real productive factors. He can simply borrow purchasing power and buy them off from other uses. He requires credit in consequence of the logic of the process of development. The corollary is that credit serves the need of industrial development.

---


(2) Joseph A. Schumpeter - Economic Development, Ch - 3
This may be called "Credit inflation". But it is different from credit inflation for consumption purposes. The main function of the money or capital market is trading in credit for the purpose of financing development.

There are thus, very cogent arguments in favour of monetary policy as an aid to development. First, there is need for pooling, as far as possible, the resources of an underdeveloped economy for productive investment. Secondly, there is also considerable scope for changing the composition of investment and a positive monetary policy can largely help in this direction. Thirdly, the real obstacles to development are so great in underdeveloped economies that it becomes all the more necessary that development should not be further hampered by inadequacy of financial resources. Finally, apart from its expansionary impact a conscious monetary policy can also be of use in the opposite direction. For, a discriminating monetary policy can help in keeping within check the inflationary tendencies that seem almost inevitable in implementing a programme of economic development.

There are definite limits to the scope for deficit-financing and possibilities of new taxation in underdeveloped economies. Therefore, simultaneous reliance should be placed on
deficit financing, taxation and bank credit. Secondly, the banking system can impart an elasticity and flexibility to the money supply by providing funds when and where they might be required and by withdrawing funds from sectors where their use should be curtailed.

Thus the conclusion is that the monetary system is neither a purely passive factor in economic development, nor is it a causal factor initiating the growth process. But as a contributory factor, its role may be quite significant.

The potentialities of monetary policy to prevent inflations and deflations are greater in an underdeveloped economy than in a more developed one. For in the former the aggregate demand for goods and assets responds more closely to changes in the stock of money. Whereas in a country like the U. S., additions to the money supply may lead to an addition to the stock of idle balances, in an underdeveloped economy they are more likely to lead to an increase in aggregate demand. For one thing, faith in the currency is usually lower in these countries due to persistent inflationary tendencies. Secondly, the bulk of the people have such low real incomes that any increase in money income is bound to lead to higher levels of consumption. Thirdly, there is the prestige attached to holding particular types of assets, such as real estate. (1)

(1) David L. Grove - "Objectives and Potentialities of Monetary Policy in underdeveloped countries" Ch. I of "Central Banking in underdeveloped countries" - a doctoral dissertation submitted to the Harvard University, April 1952; received by the courtesy of the author.
The role that can be played by the banking system will be limited in its effectiveness, no doubt; still, the Central Bank, with its powers of controlling the availability and cost of credit, will act as an important guiding factor. Its success in curbing inflation and encouraging productive investment will provide an important stimulus to the inflow of capital from abroad.

**Inadequacies of Monetary Institutions.**

Monetary institutions in underdeveloped economies have often been moulded in the pattern found in Western Countries. But they have hardly proved suitable in the different economic context.

Financial institutions of backward economies are mainly of two types. First, there is an organised banking section following Western methods of business. Second, there are numerous other credit institutions, local in character, heterogeneous in structure and operations. Some of them are not even worth the name of a bank. They finance mainly internal trade and agriculture. Sometimes, their methods of business are quite developed, as in India. Often, however, they are primitive in character and follow many undesirable practices.

The modern type of banking in the countries of South, South-East Asia and Africa was imported from abroad. The banks are of both foreign and local origin. Frequently, they have been founded and
conducted by people from the West, or else they have simply been branches of banks incorporated elsewhere, such as London, New York, or Amsterdam. The British or Dutch were initially traders. They set up banking institutions as a necessary corollary to their commercial functions. Even those that are of local origin and management, have been exact replicas of the foreign model. In some countries banking institutions of local origin have been few or non-existent. The organised banks are thus only relics of the colonial past of such countries. They are mostly branches of some big foreign bank. They have no interest in the needs of the country in which they operate. They help in financing only those occupations which are of interest to the foreigners, such as export and import trade, or industries started by foreigners. They also finance primary production for export. But those lines of production whose development is the first step towards industrialisation, are neglected. In India, foreigners have actually obstructed the growth of banking, shipping, insurance, brokerage business among Indians.

While, therefore, underdeveloped countries suffer from a chronic shortage of capital, the domestic supply of capital often tends to be frittered away in feeding those enterprises which are quite developed and where the need for capital is the least. Undue influence of foreign banks and foreign financing institutions in underdeveloped countries has clearly led to emphasis on the financing of
foreign trade, a tendency to hold balances abroad and a greater
susceptibility of the domestic economy to financial crisis abroad. " (1)

Even the organised banks of local origin have emulated
the tradition and working of the foreign banks. In general, there
is a bias towards short-term commercial loans, while industry and
agriculture suffer from a chronic shortage of finance. In the
absence of reliable corporate securities in which to invest, the
dearth of capable entrepreneurs and the subsistence character of
agriculture, banks have no other alternative.

In these countries, entrepreneurship for the more
actively productive types of investment is not usually forthcoming.
Credit flows to less productive and passive forms of investment like
holding gold, jewelleries, landed estate etc. both because they are
safe and because they are quicker yielding types of assets. This
difficulty has often been sought to be remedied by selective methods
of credit control. But the borrower may evade such control by showing
an apparently productive purpose for the loan, while he releases his
own funds for non-productive uses. In the absence of reliable credit
appraisal methods, the banks cannot assess all the productive require-
ments of the applicant.

(1) United Nations - Domestic Financing of Economic Development,
1949. P. 60.
The second drawback of the monetary mechanism in these countries is the ineffectiveness of central banking control. The multiplicity and infinite variety of credit institutions also largely impair the ability of the monetary authorities to exercise any effective degree of control over them. Many of the non-institutionalised credit agencies are perfectly independent of the Central Bank on account of the adequacy of their own resources. Credit control is further handicapped because the constituent elements of a money market are not properly organised. Conspicuous by its absence is an organised bill market.

There has been some noticeable development of Central banking in countries of Asia and the Far East. Many of them are comparatively recent in origin, being set up in many cases after World War II. So their status and powers of credit control are often underdeveloped. In some cases, such as Ceylon, Korea, the Philippines, India and Pakistan, legislation gives the central bank considerable powers of control over the commercial banks. On the other hand, legislation in Burma and Indonesia gives the Central Banks very little of such powers.

Among different types of financial institutions commercial banks have made noteworthy progress in these countries because of the early establishment of branches of well-known foreign banks. Commercial banks, however, play a comparatively unimportant part
here because of the strong liquidity preference of the people. In most countries of the South East Asia region, demand deposits amount to over 80% of total deposits. The only exceptions are India and the Philippines. This limits the ability of commercial banks to make long-term and medium-term loans. Commercial banks are the most important institutional means for attracting savings or time deposits. Inability to attract deposits is often due to deliberate policy on the part of banks. Thus commercial banks in Burma and Ceylon discourage large deposits of funds and pay interest rates as low as 1% on savings deposits. Except in India, Pakistan and a few other countries, the proportion of cash held by commercial banks is very high. Consequently loans and advances are small. In general, the total amount invested is a very small proportion of total deposits in these countries.

Another difficulty is that the number of bank offices is very small. There are some areas where there are no bank offices at all. Thus in India, some areas are grossly underbanked. On the other hand there is a concentration of bank offices in large urban centres, resulting often in unhealthy competition and lack of business for banks. This hinders a systematic mobilisation of savings.

(1) U.N. - The Mobilisation of Domestic Capital in certain countries of Asia and the Far East - p. 36.
India is more fortunately placed in these respects than many other countries. The capital market in India is the most extensive and most institutionalised among those of all the countries of the ECAFE region. Underwriting has been quite common during the last twenty years or so, being undertaken mostly by firms of stockbrokers and lately by investment companies, joint stock banks etc. However, excessive speculation in stock exchanges may at times hamper healthy investment.

In the context of planned economic development, the banking system can and should play an increasingly significant role. Economic development should, therefore, be accompanied by a development of the banking mechanism, both qualitatively and quantitatively.