A modern economy is necessarily a monetary economy. The introduction of money has greatly facilitated exchange and reduced the cost of transactions. Money is regarded as a form of wealth and the most liquid of all assets. However, the lack of consensus on what money is has often been a reason for disagreement amongst the economists about the role of money in the economy and about the aims and limitations of monetary policy. There are at least two inter-related problems in most definitional processes namely the problems of definition itself and also that of classification. By definition we mean a precise statement of the essential nature of a thing. By classification we mean the detailed enumeration of those items that accord with the definition. Disagreement exists about both definition and classification or at least there is agreement about one but disagreement about the other. Most definitions of money emphasize, the medium of exchange and means of payment function ignoring its function as store of value. Inspite of theoretical developments and empirical evidence the classification of money supply has been quite divergent and only we find some degree of standardization in international financial statistics. In India the Reserve Bank
appointed several working groups from time to time regarding classification of money supply and the working of the monetary system. Since our study is confined to India we adopt the classification of money supply in terms of four categories namely \( M_4 \), \( M_3 \), \( M_2 \) and \( M_1 \). For all practical purposes \( M_2 \) is used in Monetary Planning in India.

Monetary planning is based on monetary transmission mechanisms and the channels of monetary influence. The transmission mechanisms differ from one another in the way the changes in money supply working through intermediating variables bring about the changes in the goal variables. The monetary transmission mechanism refers to the general conceptual framework within which the analysis of monetary disturbances may be undertaken, whereas the channel of monetary influence refers to the route through which these monetary disturbances influence the goal variables. There are four transmission mechanisms that are emphasized in the literature. They pertain to (1) Money supply link with portfolio balance and thereby influencing prices, output and employment (2) Money supply link with wealth (3) With credit availability and (4) With expectations influencing prices, output and employment. The four transmission mechanisms differ in their operation in an open economy as compared with closed economy on one hand and developed economy in relation to developing economy where the Monetary mechanisms and financial systems are less developed and characterized by
dualism i.e., organized and unorganized segments with limited interaction between them. In such a context monetary planning tends to be ineffective unless it is supported and supplemented by fiscal and other selected policy instruments. We propose to deal with a brief review of literature pertaining to monetary structure, financial systems and allied aspects and their transmission mechanisms in developed and developing countries to provide the background for our investigation into the case of India.

1.2 MONETARY THEORY AND FISCAL POLICY:

Hansen's¹(1949) work is devoted mainly to the subject of money and it gives a much fuller discussion of the role of money. Money supply does play an enormously important role in economic life. There is an optimum money supply, but the matter is not as simple as the quantity theory made it.

He discusses the creation of money in a federal system in an analytical manner for computation for finalizing various monetary issues of federal reserve system of U.S.A. He discusses the quantity theory of money with particular reference to Marshallian approach to find out the relationship between money, output and prices. He explains the liquidity preference of Keynes, investment and consumption functions.
He highlights four factors to determine the relation of the rate of interest to income (1) investment demand schedule (2) the consumption function (3) liquidity preference schedule and (4) the quantity of money created by the monetary authority. In this process he formulated IS, LM curves approach to determine the rate of interest which is the key issue in Monetary management. This book analyses the relationship between income and the rate of interest and how they are mutually determined by (1) the marginal efficiency of capital schedule (2) consumption function (3) the liquidity preference (4) the quantity of money.

Income theory of money and prices involves not only an analysis of aggregate demand and income, but also of costs and aggregate output keynes' approach is the income approach. It is the volume of expenditure, not the quantity of money, to which primary attention must be given. Monetary policy is nonetheless important. But the quantity of money is relegated to a secondary, though still significant place.

The proposals having to do with monetary restraints cannot be regarded as in any sense a solution to the problem of inflation. There is needed instead a many sided attack on the problem, including the following.

1. Judicious use of monetary policy, moderate control of the use of credit.
2. Fiscal policy maintenance of high tax rates scrutiny of expenditures and postponement of all capital outlays not
justified on strong grounds of national policy. A large treasury cash surplus must be the core and centre of an anti-inflationary programme.

3. In addition to the judicious use of monetary policy and firm use of fiscal policy, minimum direct controls, including allocation of scarce materials for essential uses, construction permits and rationing are needed.

He analyses the role of money in fiscal policy. In the usual case government outlays are likely to affect the capital market adversely unless accompanied by monetary policy designed to increase the quantity of money, thereby preventing a rise in the rate of interest. A low rate of interest can be achieved by financing a portion of the income generating outlays by borrowing from the banking system. For the rest of borrowing from the public will restrict consumption outlays less than tax financing even though a progressive system of taxation is applied. In so far as the outlays are tax financed, progressive taxation will restrict consumption less than regressive taxation, but may adversely affect investment. Therefore fiscal policy supplements monetary policy. The current post-war inflationary pressures make it sound policy to reduce the public debt, and particularly to retire the bank holdings of Government securities. But there is little evidence that any clear distinction is being made in public thinking between what is appropriate now and what may be appropriate monetary policy over the long term. There are many signs that are again setting down into a frozen mold from which it may be difficult to escape. A dynamic and expanding economy will need a monetary policy flexible enough to give us
a money supply commensurate with our growing productive potentialities.

This book shows what monetary policy can and cannot achieve and why it has often failed in the past, the necessary supplementary role of monetary policy as an aid to fiscal policy in periods of both depression and inflation as prerequisites for assuring a stable economy.

1.3 QUANTITY THEORY OF MONEY - A RESTATEMENT:

Friedman's\(^2\)(1956) "Quantity Theory of Money - A Restatement". Marked the resurgence of modern economists interest in the quantity theory of money. In this essay he has asserted that "Quantity theory is a theory of the demand for money". The statistical analysis of the relative stability of monetary velocity and the investment multiplier in the united states during 1897-1958 have opened a new chapter in the study of monetary problems.

The demand for money is determined basically by (a) total wealth and (b) the returns on various forms of wealth. However, in emphasizing wealth rather than income as the relevant budget constraint, Friedman was then faced with the problem of finding an acceptable measure of wealth to include in the demand for money function.
To overcome this problem Friedman made use of a basic principle of capital theory i.e., that wealth is simply the capitalised value of income. Basing his analysis on capital-theory concept Friedman then rejected the use of current income as a proxy for wealth because in the short run current income is subjected to erratic fluctuations. Instead Friedman introduced into monetary analysis a longer term concept of income one which he had developed in his work on the consumption function i.e., permanent income. This is an average of past, present and future incomes and conforms closely to an individual's expected or normal income. In this way Friedman refined the income concept until it approached a wealth concept and he then included permanent income in the demand for money function as a proxy for wealth.

Wealth, however is important not only in providing the relevant budget constraint but it has important effects on the demand for money through the various forms in which wealth, specially in human or non-human form, pinpoints the other two general determinants of the demand for money.

1.4 RADCLIFFE REPORT:

The Radcliffe Report\(^2\)(1959) received considerable critical acclaim for the high standard of its description of the U.K financial system and its institutions. At the same time, however, it gave rise to some criticism that the Report
had not given sufficient weight to the importance of regulating the quantity of money as part of economic and financial policy. In the late 1960's the U.K government became increasingly criticized for following too closely the recommendations of the Radcliffe Report, which were embedded in the U.K. treasury's is and Bank of England's Philosophy. The Radcliffe Report had concluded that monetary policy should give priority to controlling the liquidity of the monetary system, and not the quantity of money in the system. Rejecting from among such measures any restriction of the supply of money, the Committee advocated measures to strike more directly and rapidly at the liquidity of spenders.

The Committee regarded a combination of controls of capital issues, bank advances and consumer credit as being most likely to serve this purpose. Reasons for taking this view were the theoretical difficulties of identifying the supply of money and the haziness that lies in the impossibility of limiting the income velocity of circulation. Nevertheless, the Report did not dismiss the quantity of money as unimportant, but rather believed that given proper control of liquidity it would look after itself. The Committee did not regard the supply of money as an unimportant quantity, it viewed it as only part of the wider structure of liquidity in the economy. In external policy, the Report came down in favour of fixed exchange rates. It would be more difficult if there were no fixed rate to be defended, to keep domestic
costs in line with costs abroad, and the need to devalue might result from the very ease with which the external value of the currency would be adjusted. The Report gave support to the need to strengthen the international liquidity position and saw much merit in strengthening the I.M.F. along the lines of the keynes plan.

1.5 KEYNES' MONETARY THOUGHT - A STUDY OF DEVELOPMENT:

Patinkin (1976) has written this book to obtain an overview of the development of keynes thinking on monetary problems during the fifteen year period that culminated in the appearance of the General Theory.

Keynes already in the treatise had the embryo a very different kind of aggregate demand theory that combined with his theory of aggregate supply as presented in the general theory would have led him to an altogether different type of Macro Model Viz, a genuine quantity theoretical macro model. The treatise made great play with the Fisher relation MV=PT, which written as $T = \frac{VM}{P}$ may be interpreted as an aggregate demand schedule with total demand completely dominated by real balances and unit elasticity of demand with respect to price. Combining it with his short term aggregate supply schedule which we can write as $T = f(P/W)$, 'W' standing for the given money wage rate. Keynes could have come out with a very simple macro model that would have shocked nobody and might
have served as the logical foundation for "crowding out" thinking and the like. Had Keynes in his search for an aggregate supply theory not stumbled upon the entirely new concepts of consumption and investment functions and added those together to a total aggregate demand, happily forgetting about the constraint of the Fisher-relation, we might all have been brought up as faithful quantity theorists with a Keynesian modification for the short term, Friedman might never have had a chance of convincing the profession that quantity theory is a theory of demand for money rather than a theory of demand for commodities and services and the whole world would have been different and better are we to believe the Wall Street Journal.

1.6 **MONEY, FINANCE AND DEVELOPMENT:**

J. Joseph Drake (1980) explains with a standard description of flow of funds accounting. He writes "subject only to the availability of sufficient data the construction of flow of funds accounts is the desirable first step in studying money and finance in any developing economy".

He deals with Ronald Mckinnon's complementarity hypotheses - money and physical capital as complementary assets. He concentrates on the money supply process in small open developing economies. The material on the currency board
system and exchange rate policy for tiny open economies presents a clear survey of relatively recent work.

He concludes that informal finance plays an important role in the process of financial development and that policy should aim at integrating the informal and the formal financial sectors. "The policy would in many countries entail a considerable rise in interest rates within the financial sector". Developing countries are advised that they may have to face (1) Bad lending attitudes of existing financial institutions. (2) Establish new specialized financial institutions and; (3) Foster the development of a securities market. Subsidies may well be needed. In particular, Governments should expect to subsidize the supply of credit for farmers and small farmers and small businessmen to redress capital market imperfections.

He stresses the need for developing a securities market. In the right circumstances low inflation and free interest rates subsidies for securities market development may be justified.

1.7 SUPPLY AND DEMAND FOR MONEY AN EQUILIBRIUM ANALYSIS:

Patnaik's main focus is on conceptual clarity in regard to the supply of and demand for money and to articulate how they act and react with each other around the mainstream. In
this process, attempts have been made to subject the theories to rigorous interpretations and reinterpretations, casting and recasting, in order to fit them in an equilibrium analysis. The problems of money supply and demand have been put in an equilibrium framework and policy implications drawn. It also tends to bring monetary and capital components of financial flows into convergence towards an unified analytical and academic treatment.

He analyses the importance of money supply, sources of money supply and what is the just amount of money.

The book deals with the role of central bank to control of money supply through its direct and indirect controls and its limitations. It also discusses role of non-bank financial intermediaries in the economy and the role of Central Bank to minimize the role of non-bank financial intermediaries.

He highlights the prospects of monetary policy to control inflation and to achieve growth with stability and full employment. In fine he analyses the limitations monetary policy in terms of pegging of interest rate and pegging of unemployment.

1.8 MONETARIST PERSPECTIVE:

David Laidler'(1982) concentrates on monetarism, say's
law, money and business cycle. He develops recent theoretical developments in macroeconomics into historical perspective.

The defining characteristics of monetarism for Laidler are two (a) belief in a stable demand function for money and (b) distaste for government interference. Much of Laidler's discussion is an explanation of why he feels that a stable demand function for money does not justify activist monetary policy. This advocacy is made harder by his rejection of many of the theoretical conclusions of the rational expectations school.

He believes in stable demand for money. The demand for money is a function of relatively few variables, but this leaves open the question of occasional disturbance from additional variables and of the frequency and importance of those perturbations.

He devoted much attention to discussions of econometric evidence on the role of money in the economy. Presumably it is the econometric evidence which Laidler has in mind when he asserts a stable demand for money.

"On the case for gradualism" he reaches conclusions contrary to those in Thomas Sargent's paper. The end of four Big inflations, (1981) which claims that sharp, unambiguous policy brakes have been effective in reducing inflation rates
without major loss of output. Here, as elsewhere, Laidler argues on the basis of plausibility.

1.9 THE SCOURGE OF MONETARISM:

Kaldor's (1982) book brings together his Radcliffe Lectures and his evidence to the treasury and civil service committee. It also has a dual character in another sense. Comprising both an attack on monetarism and an attempt to convey some more positive ideas.

At the centre of Kaldor's critique are the following propositions; (a) the automatic adjustment market clearing, and flexible prices postulates are not helpful in explaining the behavior of an actual economy; (b) credit, money and money substitutes make an important difference to the way the economy works and complicates, to say the least, the problem of controlling the money supply, however, that is defined; (c) the reaction mechanism of the economy so long treated in a casual and cavalier fashion by monetarists, is essentially Keynesian and (d) attention must be paid to the source of shocks to the system, most notably, of course those of a cost push nature.

Kaldor himself seems sometimes to be saying that the money supply is fully endogenous and some times that, given the institutional structure of the city of London, control can
only be obtained at a high price. There is a word of
difference, however, between the propositions it is difficult
to control the money supply; and it is impossible to control
the money supply. In both cases, of course the time horizon
over which control is to be exercised is of vital importance.
A similar comment applies to the demand for money. It may be
doubted whether a suitable function exists in the full sense
that some monetarists have claimed, but it is hard to accept
as keynesian or correct that there is no such thing as the
demand for money determined relative to expectations of price,
income and the rate of interest.

Kaldor is a Radcliffian in the sense of emphasizing total
liquidity and the range of assets which may be substituted for
each other and money in a portfolio. Given that view it is
reasonable to include foreign assets in the set that needs to
be examined, from which it follows that in the absence of
rigid exchange control domestic interest rates cannot be
isolated from foreign ones. The portfolio balance theory of
the interest rate and exchange rate is, therefore quite
compatible with keynesianism, equally to the point, the
endogeneity and controllability of the money supply are to be
seem more clearly as issues in an international context than
a purely domestic one. Lastly, reference must be made to
Kaldor's own policy recommendations. The key propositions are
(i) a total income freeze. (ii) a freeze on all domestic goods
prices. (iii) a guarantee of an inflation rate of at most 2%
per annum. (iv) an export levy and an import subsidy on fuels (v) further import subsidies and indirect tax reductions. (vi) import controls on competitive imports or a dual exchange rate system (vii) reduction in the rate of interest and the external value of sterling.

1.10 FINANCIAL SYSTEMS AND DEVELOPMENT:

Development strategies in the 1960's and 1970's influenced the shape of financial systems in developing countries. In many countries the growth of robust and efficient financial structures was retarded by government intervention that was designed to direct credit to priority sectors and to keep interest rates artificially low. Today as many countries have tended to revise their approach to development to rely more on the private sector and on market forces, the need for financial reform has become clear. The necessary changes in policies and in financial institutions, instruments and market changes that offer countries an opportunity to fashion financial systems capable of providing the services their economies will need in the future are the subject of this twelfth annual World Development Report.

The Report reviews the financial history of both high income and developing countries, including the policies and events leading to the present distress of so many financial intermediaries. It then considers the prerequisites for the
development of more efficient financial systems, Restructuring troubled banks and the unprofitable firms that have borrowed from them, restoring macroeconomic stability, strengthening the legal, accounting and regulating frameworks of finance, improving the management of institutions and developing a more diverse set of institutions and markets.

The Report also reviews the attempts at financial liberalization made by the some countries.

Chapter I describes the global macroeconomic environment that has confronted developing countries in recent years and discusses two scenarios for prospects to the end of the century. Even under the more optimistic of these, the developing countries face serious economic challenges.

Chapter II introduces the main body of the Report and examines the role of finance in development. It argues that finance matters in more ways than might be immediately apparent. Efficient financial systems help to allocate resources to their best uses and are indispensable in complex, modern economies. In many developing countries as some of their governments have begin to realize the financial sector is in urgent need of reform. Reform will not be easy, but the difficulties faced by developing countries as they seek to improve their financial systems are not new.
Chapter III charts the history of financial institutions in the industrial countries. It shows an often unsatisfactory mixture, innovation in response to the needs of growing economies but many disruptive episodes of financial instability. Failures and fraud in their financial systems have led governments to intervene extensively.

Chapter V describes the difficulties of financial institutions in many countries and the steps taken by some governments to address the problems of their financial sectors. This experience has led the developing countries to reassess their financial policies. A search is underway for policies that will strengthen the financial sector so that it can make its full contribution to the efficient use of resources, while keeping its tendency toward instability in check.

Chapter VI examines the legal and institutional changes that should be part of this reappraisal. Chapter VII and VIII show in more detail the current provision of financial services to the corporate and non-corporate sectors and explore ways in which these services might be improved. Chapter IX discusses the lessons that can be learned from the developing countries that have already begun to liberalize their financial sectors.
The Principles of Financial Intermediation:

A.N. Mcleod's book clearly recognizes that credit is now a days the financial variable causing changes in aggregate spending. Second it correctly treats financial intermediation as the "theoretical core" of modern money and banking. Third, it recognizes that intermediaries whose liabilities are 'Money' are one species of large genus.

Theoretically it covers not only "long run general equilibrium models", but also "short run disturbances" so called dynamic models. It deals with both "closed" and "open" and domestic and international intermediation.

He avoids letting "real" analysis muddy up, as it so often does, financial analysis and he uses, meaningful conception of 'saving' for use of monetary and financial analysis.

He employs the traditional inverted "pyramid" paradigm to analyze the creation of credit. The reserve ratio's of intermediaries and the "acceptance ratios" of their liabilities by the public provides his scaffolding. He typically takes these ratios as fixed.

He over emphasizes the influence of what he calls "Standard Money" and uses it as the foundation of his pyramid.
After first adopting D.H Robertson's sensible definition of money, as anything which is widely accepted in payment for goods in discharging other kinds of obligations", he identifies "standard money" more explicitly as either the monetary obligations of the central bank or a commodity money.

He employs a "total income multiplier" derived by compounding "credit multiplier" and a "standard income multiplier". He postulates that for the standard income multiplier to operate, the 'saving' at each round must be returned to the intermediaries in forms, which permit them collectively to increase their net lending correspondingly.

1.12 POST KEYNESIAN MONETARY ECONOMICS:

Stephen Rousseas's\(^{14}\)(1986) book gives a lucid and entertaining account of the endogenous money hypotheses in Post Keynesian monetary thought including a markup theory of the rate of interest and his own alternative theory of an endogenous money supply. What Rousseas is keen to emphasize is that in the light of the stagflation episode and the policies of setting monetary targets and deregulating financial markets which followed it, the Post Keynesians cannot counter attack at a policy level only through a call for income policies. They must in addition in the light of their own arguments and a revival of the arguments of the Redcliffe Commission, call for selective credit controls in an
over all package deal of policies. Selective credit controls are the logical policy implication of explicitly taking credit money into the theoretical model of how the economy works.

1.13 MONEY AND MONETARY POLICY IN INDEPENDENT NATIONS:

Ralph Bryant (1980) has produced a treatise with the theme; the role of money in monetary policy in independent national economies.

Inevitably the starting point is the dubious nature of the concept of money which, however defined, is not a policy instrument (as some macro models imply) but an endogenous intermediate variables linking monetary policy instruments to ultimate targets. This link is uncertain and subject to economic policy disturbances in a closed economy; and it is more uncertain in an open economy, even one with an unconstrained exchange rate. The theme of interdependence is developed first in general terms, demonstrating that the greater the openness (precisely defined) the smaller the degree of control the authorities can exert over national target variables; and the same is then shown to apply to money.

This is necessarily a very greatly reduced form; of the weighty theoretical structure upon which the author bases his central conclusions; (i) the money stock cannot be defined in
such a way that it will be impervious to external interactions and (ii) there is no national monetary aggregate that central bankers can control closely and that has a direct reliable relationship with ultimate targets. Hence, the rejection of a two stage strategy using money as an intermediate target and particularly of setting a time path and seeking to minimize deviations from this. The superiority of a single stage strategy with continuous flexibility of choice of both domestic and external instruments emerges as a corollary.

1.14 MONEY AND MONETARY POLICY IN LESS DEVELOPED COUNTRIES:

Warren L. Coats & Deena R. Khatkhate's book an IMF product, comprises a survey of issues and evidence by the editors in respect of money and monetary policy in LDCs and forty eight short contributions.

The extracts are grouped into three sections. Money finance and economic development, implementation of monetary policy and econometric models. The first section is divided into two sub-sections, purporting in the first to deal with the role of money and economic development the second with monetary policy formulation. It is true that in many of the least developed countries the two roles are played by the same institutions in the absence of nonbank financial intermediaries, but the functional distinction is pertinent in view of the importance assigned to financial intermediation in the
models of Edward Shaw, R.I. Mckinnon and others. An example of empirical work relevant to this role is an extract from an article by Maxwell Fry Reporting that the real rate of interest on twelve month deposits has a positive effect on domestic savings and economic effect on domestic savings and economic growth in the seven Asian LDCs included in his pooled data regression analysis.

The largest section on the implementation of monetary policy contains contributions on the definition of money. The demand for money, money supply processes, money control instruments and other policy instruments including interest rates of the contributions in this section almost all are empirical in the sense of presenting statistical analysis or use of models. An interesting example of the latter is the report on results obtained by B.B. Aghevli and M.S. Khan using a model designed to test two way causation between money and prices associated with monetary financing of growing government deficits due to lag of revenue on expenditure. The model, when applied to an heterogenous groups of LDCs (Brazil, Colombia, the Dominican Republic and Thailand). Confirm the lag hypotheses and the two way causation. Moreover, the countries with longer revenue lags were those which had higher rates of a inflation.

In the section on econometric policy models the first two contributions discuss suitable model specifications. The
other three report results of estimation; one on credit policy in respect of eight LDCs; one on price and output behaviour in India, the other from a macroeconomic model of the Philippines.

1.15 **MONETARY TRENDS IN THE UNITED STATES AND THE UNITED KINGDOM**

It attempts a statistical and theoretical analysis of monetary relationships over periods considerably longer than that of the observed business cycle. In order to analyze these longer term relationships it is necessary to transform annual data into a form free of cyclical disturbance, since temporal comparisons can be seriously distorted if initial and terminal dates reflect different stages of the business cycle. The method employed here, that of taking the average of annual observations over a cycle phase (a half cycle) is not entirely satisfactory since it cannot eliminate the influence of major fluctuations entirely and it encounters problems of asymmetry.

It attempts a comparative analysis of experience in the U.S. and U.K economies. This has entailed the need to compile homogenous and consistent monetary data series for the two economies over a considerable period of time which monetary researches will find invaluable. Less useful perhaps is the combination of U.S. and U.K data, obtained by involving annual exchange rates, to permit a one economy analysis.
It reflects the enormous outpouring of research on monetary theory and policy generated over the past two decades which provides if only partially, a firmer theoretical foundation and justification for the quantity theory orientation offered here. The authors have in the past, been criticized for possessing no monetary theory as such and for basing their brand of monetarism solely upon what their empirical studies have led them to conclude. Friedman, in particular has been theoretical in providing no rigorous determination of the monetary mechanism and of being prone to all the dangers of statistical inference in the absence of a precisely articulated theory. This book goes some way to meet this criticism in that a detailed theoretical framework of the quantity theory is offered which deals with the adjustment process and outlines an implicit monetary mechanism incorporating the role of expectations. Through out the emphasis is upon how monetary change exerts an influence upon asset stock and not just upon expenditure flows as emphasized in Keynesian oriented analysis.

Needless to say, it is the conclusions of the study which will spark most interest and controversy. These argue that a single demand for money function applies to both the U.K and U.S economies; differing substantially only with respect to their real income elasticity. The use of single equation approach to the demand for money generates problems of identification, but nonetheless these findings are impressive
and point to the similar influence of the differential between the interest return on financial assets and money, and the yield on real assets as important determinants. As to be expected it is demonstrated that the level of nominal income parallels the level of the nominal quantity of money and likewise that the rate of change of nominal income parallels the rate of change of the nominal quantity of money for both the U.S and U.K economies. More interestingly, the decomposition of nominal income change into its price and output components differs between the two economies with little evidence of monetary change on output for the U.K, whereas some transitory output change does appear to exist for the U.S.

1.16 THE ROLE OF MONETARY POLICY IN ECONOMIC DEVELOPMENT:

Hirendranath Ray's (1962) study is an attempt to fill the gap by concentrating on the monetary and financial counterpart of real growth and by showing when and how monetary policy does contribute to economic development. Attention is focussed primarily on the case of India since the R.B.I has significantly departed from orthodox central banking principles and has adopted a truly growth oriented monetary policy. The achievements and failures of the bank's policy point to the type of monetary measures suited to the requirements of growth.
In backward agricultural economies, the main objective of monetary policy is the development of the economy. In such economies a growth-oriented monetary policy is needed and a policy of credit creation for financing development assumes importance. He advocates inflationary financing of development, and shows that the arguments against moderate inflation are either fallacious or based on subjective value judgements. He emphasizes on control policy of the central bank to achieve relative stability and the adequate provision of rural credit is necessary in the development process.

He advocates growth oriented monetary policy through the provision of industrial credit. The central bank must see that savings creation and savings mobilization are effectively done. This can be achieved through the creation of financial intermediaries.

1.17 MONETARY POLICY IN A DEVELOPING ECONOMY:

C.K. Johri¹⁶(1965) explains the policies related to the control money supply, the distribution of bank credit, the level and structure of interest rates, the development of sound financial system the extension of credit facilities to rural areas.

He explores the suitable monetary policy definition to India related to the decisions of the government and R.B.I
which affect the volume and composition of money supply, the size and distribution of bank credit the level and structure of interest rates and the effects of these variables upon the factors determining output and prices.

The purpose of his study to two fold. First to appraise the effectiveness of the monetary policy of the R.B.I in regulating the banking system and second to compose the impact of credit policy upon the Indian and foreign scheduled banks in different size groups. The criteria for the appraisal are furnished by the policy doctrine of "controlled expansion" with its contradictory emphasis on both growth with stability.

He maintains in this book that monetary policy can be made more effective in inflation control is accepted as a goal of policy and an upper limit on the permissive rate of increase in price level is laid down in advance. Further in carrying out of its policy the Reserve Bank should clearly know its own sphere of action, in respect to which it should be fully autonomous.

1.18 MONETARY PLANNING FOR INDIA:

The Book by Suraj B. Gupta (1981) highlights the changes in money supply which have wide ranging economic repercussions, such changes need to be planned and made with in the framework of a coherent monetary policy.
This study explains monetary planning in a systematic manner in the context of planning models. Monetary planning covers the controlled changes in stock of money to subserve well defined objectives. The study discusses the main objectives of monetary planning, supply of money changes and the sources of change in high powered money, the key factor responsible for changes in money supply.

The discussion in this study combines theory of monetary system with empirical evidence and a critical evaluation of the conduct of monetary policy and uses of monetary control measures with positive suggestions regarding what can and should be done to attain well specified goals. Monetary institutions and practices as they have operated over the period covered (1950-51 to 1976-77) have been explained evaluated and woven into the discussion at all steps.

The study further attempts planning of money supply by the R.B.I with the advice of the central government. In this situation the monetary authority of R.B.I is severely limited and the government comes to exercise enormous monetary powers. Here R.B.I acts as department of the government. Therefore, it is of the utmost importance for sensible monetary analysis as well as planning to recognize this fact explicitly and to make the government jointly responsible with the R.B.I in the task of monetary planning and control with government as the senior partner. The chief prerequisite for successful
monetary control is the control of deficit financing by the
government. The precise implications of neutral money policy
for the governments deficit financing will have be worked out.

1.19 INFLATION IN INDIA:

Ranganadhachari¹⁸(1981) explains the inflation in India
through the structuralist monetarist controversy. The
structuralists analysis of the inflationary process lays great
stress on the connection between inflation and growth.
Inflation occurs essentially because the forces of growth
encounter certain strong resistance. Monetarists on the other
hand argue that effective way of checking the rate of
inflation is to check the rate of growth of money supply.

He analyses the prevailing institutional factors and
structural changes in Indian Economy under two heads
international and domestic. There can be no two opinions that
inflationary pressures originating in some countries tend to
get themselves transmitted to others through trade and
exchange arrangements. Among the domestic factors that have
contributed to the price rise in India are the basic plan
strategy, ineffective controls and institutional reforms,
absence of wage - income policy, the inflationary role of
distributive traders etc., have been mentioned. The changes
in the structure of domestic production both in the
agricultural and manufacturing sectors clearly indicate the
built in nature of inflationary pressure. Further, the policies relating to import substitution and export promotion have been bringing about such structural changes in production which adversely affect the price level.

From the above discussion, the structuralist variables that impinge on price level have been identified and some of them relating to fiscal developments and foreign trade are included in the regression analysis. In testing the significance of structuralist variables, due to the absence or inadequacy of theoretical framework with appropriate empirical counterparts, the formulations of the equations and choice of variables largely represent groping.

The discussion in the book shows the anti-inflation war must be fought over a wide area of the economy and not merely at the spending point. Apart from demand management through monetary and fiscal measures, an effort should be made to manipulate institutional and structural factors to tackle the problem of inflation in a long run perspective.

He analyses the role of monetary policy in accelerating the economic development in an environment of reasonable price stability, through the R.B.I. The R.B.I in this connection spoke of the controlled expansion of money supply and stated that the following three considerations should constitute the basis for determining the desired rate of monetary expansion.
1) The growth of real national income. 2) The expected increase in the demand for real balance as income increases and 3) The rate of monetization of the non-monetized sector.

1.20 **MONETARY SYSTEM IN INDIA - CHAKRAVARTHY REPORT:**

There are five major building blocks in this Report. The first building block relates to the objectives of monetary policy. The effectiveness of different instruments of economic policy in pursuing different objectives is not always the same. It is in this context the price stability becomes a major concern of monetary policy, as monetary policy instruments are more effective in relation to this objective than other policy instruments.

Second building block relates to the relationship between price stability and Money supply. There has been a perennial controversy between the structuralists and non structuralists on the sources of inflation. In the Indian situation as the Report points out supply shocks are very frequent and therefore inflation cannot be treated purely as a monetary phenomenon. Nevertheless, there is enough evidence to show that all price increases in India over the last few decades cannot simply be explained by a structuralist explanation, money does count and in a significant way.

The third building block relates to the link between
reserve money and money supply. The money multiplier depends not only on the cash reserve ratio and the ratio of currency to deposits but also on the demand for credit. Addition to reserve money leads only to an increase in the credit creating capacity of the commercial banks. The actual expansion would depend upon the demand for credit which would in turn be related to the behavior of the real sector. While this position is theoretically valid, it is to be noted that in the Indian context with an administered structure of interest rates with varying rates of interest for different activities, demand for credit is not a binding constraint.

The fourth building block relates to the regulation of money supply. The major factor contributing to reserve money has been the Reserve Bank credit to the government. Therefore monetary regulations in the Indian context can be achieved only through co-operation between the government and the Reserve Bank.

In order to achieve the overall objectives of planned economic development in an environment of reasonable price stability, the Report has recommended the adoption of a flexible system of monetary targeting. Apart from defining the target in terms of range, the target range itself is to be modified as events unfold during a year. The committee has unambiguously stated that a constant money supply growth rate is not feasible in the Indian context where supply stocks are
frequent and where significant structural changes are sought to be achieved to facilitate the growth process.

The Report envisages a role for interest rate policy which is supportive of the regulations of money supply. This is the fifth building block of the Report. No doubt the important interest rates are all administered and the Report does not make a significant departure from this position. Nonetheless, as the principal participants in the money and capital markets happen to be in the government sector, certain guidelines in regard to the determination of interest rates have been presented in the Report.

Apart from the cost of the credit the Report has given considerable emphasis on two other aspects of credit. It has stressed the importance of effective utilization of credit so that with a given order of increase in money and credit, efforts are directed towards maximizing output. To the success of this task the efforts aimed at increasing the productivity of bank credit have no doubt much to contribute. It is therefore necessary to effect a change in the credit delivery system and in the credit mechanism in order to be able to achieve effective utilization of credit.

1.21 THE VAGHUL COMMITTEE REPORT ON MONEY MARKET:

The Vaghul Committee\textsuperscript{20} terms of reference were (i) to
examine money market instruments and recommend specific measures for their development (ii) to recommend the pattern of money market interest rates and to indicate whether these should be administered or determined by the market (iii) to study the feasibility of increasing the participants in the money market (iv) to assess the impact of changes in the cash credit system on the money market and to examine the need for developing specialized institutions such as discount houses, and in this context to examine the interaction between the inter-corporate market and the expanded money market: and (v) to consider any other issue having a bearing on the development of the money market.

It viewed the question of widening the money market only in terms of the number of participants. It has viewed the money market in isolation from the exchange market and the capital market.

The Vaghul group has not considered the need for linking at least certain important components of the informal money market with the formal sector. While nidhis and chit-funds function more as saving schemes, the role of indigenous bankers is different; they are an important adjunct to the formal sector in the matter of providing short term funds. They have links with banking system. Besides, they are an important source for financing stocks of sensitive commodities subject to selective credit controls.
From the point of view of development of the money market the Vaghul group analyzed the four areas of money market, which may be called four sub-markets and makes recommendation in respect of these sub-markets. The entire exercise is preceded by a lucid analysis of the present structure of and characteristics not of the overall market but also of some of the sub-markets i.e., call money market, market for treasury bills, market for commercial bills and inter-corporate funds market.

It outlines the objectives of money market which are

(a) it should provide an equilibrating mechanism for evening out short-term surpluses and deficits;
(b) it should provide a focal point for central bank intervention for influencing liquidity in the economy;
and (c) it should provide reasonable access to users of short-term money to meet their requirements at a realistic price. To achieve these objectives it adopts four-pronged strategy comprising;

(a) selective increase in the number of participants to broaden the base of the money market
(b) activating the existing instruments and developing new ones so as to have a diversified mix of instruments
(c) orderly movement away from administered interest rates to market determined interest rates and
(d) creation of an active secondary market through establishing new sets of institutions.
1.22 **MANAGING THE FINANCIAL SYSTEM:**

The Narasimham Committee\(^2\) covers the wide canvas of efficiency accountability, profitability, modernization, capital structure, administration, legislative issues, loan collection and related issues of financial systems.

It emphasizes on ensuring integrity and autonomy of operation of banks. It identified the decline in productivity and efficiency and erosion in the profitability of banks. The main causes can be identified as directed investment and directed credit programmes. Interest rates have been lower than market rate resulting in loss of profit as well as capital. Loss of profit has been attributed to rising expenses on branch expansion, unremunerative rural branches, over manning of urban and metropolitan branches and internal weaknesses, deterioration in 'house keeping' and lack of delegation as well as trade union activities.

It suggested important policy changes like abolition of branch licensing system and more liberal policy for foreign branches, continuation of computerization, depoliticalising of appointment of higher posts in banks, quality control of R.B.I and Statutory Liquidity Ratio (SLR) should be reduced to 25% in 5 years and less emphasis should be placed on cash reserve ratio. It suggested the four tier system in the operation of banking system.
It envisaged far-reaching changes with regard to priority sector financing (i) Reduction of priority sector which should include small and marginal farmers and tiny sector of industry (ii) Reducing the credit target from the present level to 10% of the total credit which is the present level in respect of these industries (iii) For the rest of priority sector a scheme of preferential refinancing should be introduced (iv) Review of directed credit system at the end of 3 years.

The committee had observed that the present administered system of interest rate is highly complex and rigid. Hence, it has recommended deregulation of interest rate. It has also suggested keeping the interest rate on deposit regulated and raising of ceiling.

It has suggested capital adequacy ratio of 4% of risk weighted assets to the raised to 8% in 3 years. Fresh capital should be obtained through capital market. For loan recovery it has suggested setting up of special tribunal. The balance sheets should be more transparent. A new idea is to set up an Assets reconstruction fund for taking over bad debts of the banks at a discount.

1.23 Money output and prices:

Narendrajadav and others²² provide extensive surveys of causality studies focussed on inter-relationship between
money, output and prices in the context of developed countries as well as in a developing economy like India.

The survey of the existing causality studies brings out a substantial divergence of outcomes. The inter-country differences in outcomes could be explained, in part, by country specific characteristics while for any specific economy, the divergence could be attributed to appropriateness of the techniques used.

The causality literature in the context of developed countries suggests that the causation could be expected to be antithetical (i.e. running from output/prices to money) if the economy is relatively more open and or if the conduct of monetary policy is based on interest rate management rather than monetary targeting. Since the Indian economy is a relatively closed one and the conduct of monetary policy in India, for long, has been based on monetary aggregates it stands to reason that on a priori grounds, the causation in India may be expected to be running from money to output and prices.

In the Indian context, several studies for example Ray and Namboodri (1987) and to an extent, Singh (1989) have concluded to the contrary. A closer look at the analytical foundation of these studies, however, shows that their antithetical conclusions emanate from the in appropriate
application of statistical tools, which provides an indirect evidence in favour of the causality running from money to output and/or prices as suggested by the conventional wisdom.

Besides this indirect evidence, the study also provides some fresh evidence on causality in India making an attempt at avoiding the common pitfalls. Using annual data covering the period 1955-56 through 1987-88 and based on the direct Granger test and modified Sims test, the study finds support for the causation from money to prices and to an extent for the causation from money to output. A mild reverse causation from prices to money also appears to be distinct possibility.

Y.S.R. Sarma's paper makes an attempt to study the relationship between money, output and prices in India. Two variants of the price equation specified in double logarithmic form have been estimated following a partial adjustment mechanism for the period 1971-72 to 1989-90. Various tests conducted on the price equation show that the behavior of prices is well explained by changes in output and M3. The distributed lag effects of a one percentage once for all changes in M3 on prices are significant for about three years following the changes and peter out progressively in the subsequent years.

Debendrakumar Das empirical study explains that the money supply and price level are closely and significantly
related. The lagged variables have larger explanatory capacity than the current variables. This means that the movements of the monetary base dominate the movements of the money supply and consequently of the price level.

The influence of current income on price level is considerable as compared to price level with one year lag and income at constant prices.

The regression co-efficient relating to both the current and lagged real income have usual signs. The real income with one year's lag appears to be statistically significant which leads us to conclude that the growth in output at least needs one year to exert depressing influence upon the price level.

The trends in money supply, Government expenditure, real income and acceleration co-efficient as estimated by us in terms of Harberger's model support positive evidence in favour of strong inflationary expectations dominantly influencing price level. The behaviour of money supply and income Government expenditure and acceleration factor have more important dominant and positive effects on prices than the variation in output.

1.24 MONETARY TARGETING OBJECTIVES AND APPROPRIATE INDICATORS:

N.A. Majumdar\(^{25}\) paper envisages the major objectives of
Macroeconomic policy have been growth, equity or social justice and price stability. Monetary policy has to be designed to subserve these objectives. The quintessence of monetary policy is to reconcile these objectives while maintaining the overriding commitment to price stability.

It highlighted the main features of monetary targeting. To preserve price stability in Indian situation, it is necessary to accord an important role to monetary policy with in an overall framework of economic policy. The feedback is to emanate from the real sector and the specific mechanism suggested for this purpose is the mid-year review of the monetary target. The target should be in terms of a precise target of expansion. The manner of implementing the target should be subjected to critical analysis by experts.

We in India have adopted monetary targeting when the major industrial economies are moving away from it. Fortunately, the modified version of monetary targeting with feedback recommended by the Chakravarthy Committee reflects the lessons learnt from the experience of the developed economies and to a limited extent, their adaptation to the specific situation of the Indian Economy. In implementing the monetary targets, moreover, the recommendations of the Chakravarthy Committee have not been followed in important respects.
The indigenous component of monetary research in India needs to be enlarged. The dual targets of $M_1$ and net R.B.I credit to government would be made more practical. It should be appreciated that overall monetary restraint could co-exist with liberalism towards selected sectors or sub sectors of the economy. The precise credit and economic activity linkages need to be studied in depth so that disaggregated credit targets could be built into the credit target. An omnibus credit ceiling is much less meaningful. Finally, the ability to lag the government is traditionally regarded as one of the important weapons of central banks. Monetary targets could be regarded as additions to the kit of such instruments.

Raising a few issues germane to the conduct and operation of credit and monetary policy in India, S.L. Shetty's paper suggests a possible re-ordering of perspectives and priorities with a view to achieving the broader development goals. Monetary targeting with emphasis on price stability has neglected the wider and dynamic role that money and credit can play in output and employment generation. The primary cause of inflation in India lies in the non-monetary sphere and price formation takes place in the commodity markets. Money supply increases follow price increases. Since money is essentially credit driven and endogenously determined, incorporation of broader development perspectives into the monetary policy framework is favoured with linkage established between output and credit and with attempts to monitor them.
A case for a flow of funds approach to credit policy is suggested with focus on credit aggregations and their distributional and discipline aspects. The paper also raises the broader question of the sustainable cost of interest for economic activities and visualizes a more consistent role for interest rate in deposit mobilization, in the demand for and supply of bank credit, and in government borrowing programmes.

1.25 ANALYTICS OF MONETARY MANAGEMENT:

Vasudevan's paper concerns mainly with the principles of monetary management in transitional economies like India. It attempts to scan the major issues in the literature on monetary economics with a view to gaining analytical insights into the transmission channels at work. The theoretical literature serves to show that changes in money supply will have price effect but may not necessarily have definite output effects. But it is possible to have effects on fixed investment or inventory and thereby on output through policies that have a being on the rate of interest. The applicability of theories to conditions obtaining in transitional economies like India would, however, have to be empirically tested.

The key issue in transitional economies is domestic debt management. To ensure that the massive dependence on the banking system for financing budget deficits is reduced, a programme of reduction of such dependence should be prepared.
for a medium term by both the fiscal and central banking authorities. In the short run-liquidity management would be best facilitated if the authorities introduce as much interest rate flexibility as possible together with market based procedures for monetary control (e.g., open market operations or discount policy) and measures for development of money markets. All these three areas of policy are closely related and would reinforce one another. They would therefore have to be considered together, they may have to be supported by reducing rules regarding security holdings or portfolio allocation and regarding cash reserve requirements.

Deena Katkhate advocate that the monetary authorities have designed an array of policy instruments to regulate credit flows in planned direction. Through this implied close consultations between the planning commission, Finance minister and the Reserve Bank, it led to a monolithic decision making process in regard to the monetary policy formulation and its implementation. As such it could not have been different in nature, impact and scope from the fiscal policy of the government. The direct rather than indirect methods of control thus have acquired a primacy in the Indian Monetary Management.

On a macro level the target of monetary policy in the Indian conditions has been the control of reserve money mainly because of the relative stability of the money multiplier over
a medium term, whether it is related to a narrow money or broad money concept.

The cash reserve ratio is used most frequently to neutralize the impact of reserve money changes on credit operations of banks. This ratio is maintained at a very high level entailing a heavy tax on the banking system. Which limits changes in it beyond a limit. Refinancing facilities, all combined together are not large enough to make any dent on reserve money variations leaving thus the open market operations as the only instrument of potency.

Statutory liquid assets ratio is not intended to be a monetary policy instrument to control either availability or cost of credit; it is the instrument employed purely to divert the private sector's saving to the public sector.

Selective credit policy is a very costly affair because it involves a heavy interest rate subsidy and non recovery of credit. The frequent changes in interest rate policy is useful to the mobilization of savings through interest rate and other organizational policies could only be a first step towards rationalization of monetary and financial policy in a country like India, contrary to what is believed by the advocates of financial liberalization.
1.26 METHODOLOGY OF THE PRESENT STUDY:

1.26(A) OBJECTIVES

The following are the specific objectives of the present study.

1. To describe the monetary fiscal situation and trends in the developing countries vis-a-vis the developed countries.

2. To define and measure Reserve money and to establish the relationship between Reserve money and money supply.

3. To examine the monetary transmission mechanism in terms of money, output and prices.

4. To assess the operation of the instruments of monetary policy.

B. HYPOTHESES

The following are the specific hypotheses of the present study.

1. There is no significant difference in the monetary fiscal situation and trends between the developing countries and the developed countries.

2. Net Reserve Bank credit to the government is not the major contributing source of Reserve money and bank credit to commercial sector is not the major source of money stock. The direct relationship between $M_1$ and Reserve money is not significant.

3. The direct relationship between money and output, Money and price level, output and price level is not significant.

4. There is no significant difference in the operational levels of instruments of monetary control.
C. **DATA BASE**

The thesis is based on the secondary data which are drawn from the Reports and Bulletins of Reserve Bank of India and surveys of Government of India. The publications of Reserve Bank, mainly Reports on currency and finance, Annual Reports, Report of the Committee to Review the working of monetary system, Recent developments in monetary theory and policy and monetary policy in India issues and evidence constitute an indispensable source. Periodicals such as Economic and Political Weekly. The Indian Economic Journal, The Economic Times and the Business Line have also been consulted apart from standard works on the subject. World Bank's World Development Reports and I.M.F.'s International Financial Statistics and Annual Reports are also consulted.

D. **TOOLS AND TECHNIQUES**

Monetary analysis is essentially an exercise in macroeconomics which deals with economy wide aggregates and sub-aggregates. The growth of money supply vis-a-vis national output, general price level involve relationships which need to be established and measured through different statistical tools namely percentages, ratio's, measures of central tendency, dispersion, time series analysis, index numbers, correlation, regression, tests of significance and analysis of variance. Compound growth rates have been computed. Diagrams and graphs have been used to illustrate the data.
E. SCOPE AND LIMITATIONS OF THE STUDY

The study is confined to management of monetary planning in India since the mid-seventies. The regulatory, promotional and developmental role of the Reserve Bank of India had been undergoing shifts under the pressure of domestic and global environment. It is not possible to investigate the multifarious facets of this complex phenomenon in a thesis like this. Hence, our attention is devoted to the traditional aspects of Central Banking Policy as it impinges on monetary management. The causality of monetary variables is assumed and established as also the several concepts of monetary analysis. Throughout, a monetarist, a positive analysis and not a normative approach characterizes the present study except where policy imperatives are present.

F. CHAPTER SCHEME

The thesis is organized into six chapters. The first chapter is devoted to a select review of monetary planning literature and methodology of the work. The second chapter deals with the monetary structure and its linkages with the fiscal and external structure in the developing countries and the constraints on the path of monetary planning in these countries. The measurement and sources of money stock and components and sources of reserve money and relationship between Reserve money and money stock are analyzed in the third chapter. The relationship between money output and
price level in India is analyzed in the fourth chapter. The fifth chapter analyses the instruments of monetary control and the constraints that impede their effectiveness in a developing country like India characterized by monetary and fiscal dualism. The last chapter is devoted to a summary of findings and conclusions.
REFERENCES:


