CHAPTER IV

MONETARY POLICY AND ECONOMIC EXPANSION

Monetary policy and fiscal policy:

As a measure to mobilise internal savings and control rise in prices for an orderly economic growth, fiscal policy in many respects is more efficient than monetary policy. The great advantage of fiscal policy is that it has direct and powerful impact on income stream, whereas monetary policy influences income stream only indirectly. Changes in government expenditure on goods and services lead to almost an immediate change in the employment of the resources used to produce these goods and services. Also, they have secondary effects through the changes thereby induced in the expenditures of the individuals owning the resources so employed. Monetary expansion by itself may not induce growth. If growth factors are operating and for the promotion of economic activity, there is need for creation of credit, monetary expansion may be salutary to accelerate the process of growth.

Similarly in case of control of consumption and investment, fiscal instrument is much more powerful than monetary policy, because fiscal policy involves a direct draft on the financial resources and purchasing power in the hands of the public, and with particular classes of producers or consumers, through use of a variety of income and commodity taxes; monetary policy, in contrast, only influences the cost or availability of
credit, which cannot be a similarly potent weapon (1). The capacity of the fiscal policy to differentiate different classes of producers and consumers according to their circumstances through commodity taxes or through reliefs and rebates is also much greater than that of Central Bank action through allocation of bank credit.

But this does not mean that monetary policy should be relegated to the background. Fiscal policy probably cannot operate without a complementary monetary policy. If the government increases economic activity, monetary authority should increase credit in sufficient quantity so as to attain the desired rate of development. At the same time, credit instruments should be properly used to control the inflationary tendency of a growing economy.

Again, monetary policy has a special merit in its relative flexibility. Whereas the mechanism for implementing fiscal policy is hampered by traditional legislative and executive procedures, monetary policy is completely outside the ordinary processes of government. The expansive or restrictive use of the instruments of monetary policy is semi-anonymous in the sense that most citizens will be unaware of their employment; it operates on the supply of money rather than, as do taxes, upon the income of individuals (2). It follows, therefore, that both the methods are to be employed as elements in a general programme of economic

(1) Dr. B.K. Madan : The Role of Monetary Policy in a Developing Economy, Reserve Bank of India Bulletin, April, 1961.

development. Monetary policy is a natural and inevitable complement to fiscal policy, since the most effective use of one depends upon appropriate use of the other. However, it should be recognised that the role of monetary policy is subsidiary or subordinate to fiscal policy in underdeveloped countries as a method of resource mobilisation for economic growth or controlled expansion for maintaining economic stability (3).

**Objectives of monetary policy:**

Keeping this in mind, we can analyse the role of monetary policy in economic growth. Monetary policy has not always been considered in terms of economic growth. As a matter of fact, the objective of monetary policy has changed from time to time according to exigencies of circumstances. Classical economists emphasised price stabilisation as the major goal of monetary policy. Hayek proposed for a neutral money. Though the objectives of price stabilisation and the neutrality of money are not identical, both relegated money to a passive role in economic affairs. Both are, in one sense, policies of neutrality: one i.e. the policy of price stabilisation aims at the neutrality of money as the unit of account by preventing changes in the general price level and the other aims at neutrality of money towards the economy by preventing changes in the total effective quantity of money (4).

As a result of this, the Central Bank's primary concern was conceived to be the regulation of the money market.

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(3) The Role of Monetary Policy in a Developing Economy, op.cit.
It was not assumed to play any positive part in the development of any part of the money market (with the possible exception of the bill market), nor was it required to extend its activities into the field of direct financing of industries or agriculture. The main purpose of the Central Bank was to regulate the cost, availability and the supply of money, not to finance the development of any thing (5). Therefore, the rate of interest was considered the most important instrument for regulation of the money market. Today there is a great change in the scope of monetary policy and the function of the Central Bank.

Another objective of monetary policy was the continuity of value. Robertson suggested that if the economy was progressing and volume of goods and services were increasing due to technological changes, a slowly falling price level would be the ideal monetary policy. This would facilitate the distribution of economic gain among all classes and especially among those whose incomes were more or less fixed. In recent years this objective has been severely attacked by a number of eminent economists like Meade, Domar, Hansen and others. For example, Meade pointed out, "..... a deflationary fall in selling prices, when money wage rates cannot easily be lowered, will impede economic growth and raise unemployment' (6). All Keynesians believe that a rising price level is necessary to maintain the development process. However, no monetary economist is prepared

to recommend a great departure from normal price movements, because that would create diffidence in money as a 'standard of deferred payments'. Moreover, the dominance of private economy in the economic system necessitates a continuity in the value of money. If the businessmen are convinced that they have stable prices to look forward to, an initial fall of prices will not discourage them. On the other hand, it might encourage inventory accumulation and equipment buying in expectation of restoration of the previous price level, rather than encourage business buyers to hold off purchases in expectation of further price decline (7).

Closely linked with continuity of value was exchange stability. In some cases, price stability could be attained only through a process of exchange stability. If the foreign trade of a country were substantial, prices inside the country were affected not only by internal economic conditions, but were also strongly influenced by external cost and price situations. Naturally, the monetary authority desirous of price stability should take necessary measures to maintain exchange stability.

The Macmillan committee in England in twenties summarised the objectives of monetary policy as follows: (8)

'The maintenance of the parity of foreign exchanges without unnecessary disturbance to domestic business, the avoidance of the credit cycle and the stability of price level'.

This was the quint-essence of classical monetary policy.

(8) Quoted from Sir Oliver Franks: Some Reflections on Monetary Policy, Asia, 1960, p.7.
Due to the impact of Keynesian economics, there was again a change in emphasis in monetary objectives. Keynes emphasised that the maximum utilisation of resources should be the main objective of monetary policy and the stabilisation of the value of money should be brought into direct relation with the stabilisation of the levels of income and employment. The Keynesian monetary approach to economic stabilisation was directly due to the fact that in a period of depression, an increase in money supply, through a cheap money policy, would increase the flow of money expenditure or effective demand and thus reduce the depresssionary tendencies of the economy. In an economy characterised by varying degrees of unemployment, a slowly rising price level was, therefore, a better monetary policy than a mere price stability.

At present, though depression does not influence the minds of the economists, Keynesian policies dominate the scene and his emphasis on the stabilisation of economy to achieve and maintain permanently a condition of full employment of resources is accepted as a major goal of monetary policy.

After the second world war, there was a further development in the scope of monetary policy and greater emphasis was laid on the need for a high level of investment to promote economic growth. Since the war shattered the economy of most of the countries, they tried to rehabilitate their economies through all possible measures. Monetary policy was also directed to the same end. The British government for example considered economic growth as one of the objectives of monetary policy. Sir Oliver Franks tabulated the objectives of monetary policy of the British government during post-war years as follows: (9).

(9) Ibid, p.10.
the maintenance of a high and stable level of employment, the maintenance of price stability, a satisfactory state of the balance of payments and lastly, economic growth'.

It follows from this that the character of monetary policy has changed from time to time. From price stability and exchange stability, it has developed to economic stability and in recent years there is emphasis on economic growth.

Monetary policy and economic growth:

The main purpose of the present study is to see the impact of monetary policy on economic growth in underdeveloped countries. This does not mean that other policy measures are unimportant. But since in an underdeveloped economy, economic growth is the major problem, the role of money in economic growth should have greater importance.

The history of monetary theory tells us that there are three board positions in regard to relation of money to economic growth (10). The first is that the quantity of money is a casual factor in economic growth. An appropriate increase in the money supply can be expected, it is suggested, to induce a regular and orderly expansion in the economy; a smaller increase will retard growth or possibly cause a contraction. This means that changes in the quantity of money (or possibly of MV) are sufficiently powerful to initiate and determine processes of economic expansion.

The second is that the quantity of money is related to economic growth in a permissive rather than a casual sense.

Appropriate changes in the quantity of money are taken not as the factor that causes economic growth but as the condition which must be present if growth potentials are to be realised or, if achieved, are to be retained. Schumpeter's theory of economic growth may be taken to belong to this category. Schumpeter stressed the strategic role of the banking system in bringing about economic development. The entrepreneur in Schumpeter's system is the innovator. But he cannot bring about innovation without an elastic supply of credit. That is why Schumpeter points out that a 'bank is essentially a phenomenon of development' (11). It is the net additional credit of the banks which entitles the entrepreneurs to combine different factors of production in a new manner and to bring about necessary change for economic development.

Thirdly, there is the income theory of Hansen which implies that money is passive and there is no direct route from quantity of money to level of expenditure or income. In some cases, increased outlay may follow from an increase in money. But generally it is the volume of expenditure on final goods and services which necessitates an increase either in money or velocity or both. Unlike the quantity theory, the sequence is likely to run from changes in aggregate demand to changes in output, wages and prices and so to changes in the quantity of money. Hansen's beautiful analogy in this connection is revealing. He points out that when a man grows corpulent, he will be compelled to wear a larger belt. But the use of a larger belt will not make any one corpulent (12).

The foregoing analysis shows that there is difference in approach regarding the role of money in economic growth. Actually, in case of underdeveloped countries, money and credit cannot play a casual role in the process of growth. Unless real resources are developed, increase in money and credit will only increase the price level. In any scheme of development, therefore, attention should first be given to availability of real factors and their proper utilisation. If suitable factors are lacking, there should be proper economic organisation to develop these factors. Once this is done, credit plan may come into the picture. The credit plan is sub-ordinate to the material plan which is formulated out of the calculations of the real resources of the economy.

Moreover, underdeveloped countries are prone to inflation in the process of their development. When investments and credits are increased to accelerate the process of development, income in these countries is likely to increase. This increased income is likely to increase the demand for consumer goods as the marginal propensity to consume is generally high in these countries. But the supply of consumer goods cannot be increased to the same extent due to backward state of technique and scarcity of capital goods. The emphasis on the production of capital goods in the process of planning would also stand in the way of increased production of consumer goods. The speculative hoarding of traders would also aggravate the situation. Traders in India have been frequently responsible for raising prices of consumer goods by creating artificial scarcity through speculative hoarding.

That is why some of the economists are strongly opposed to the development objective of monetary policy. Howard Ellis is the chief exponent of this view. According to him, since
underdeveloped countries are susceptible to inflation, any positive monetary policy to expedite economic growth is doomed to frustration (13). He is convinced that in backward countries economic growth must not be made 'an injunction upon the monetary authority'. 'Wildcat banking would not help'.

On the other hand Whittlesey argues for the development objective of monetary policy (14). Since economic growth is the primary aim of an underdeveloped country, all policy measures should be directed to attain this objective. Monetary policy in this respect is important in the sense that increase in short-term and long-term credit would facilitate development. According to Gerschenkron, the French economy which was stagnating for a long time suddenly burst into frenzied activity in the 19th century largely due to the growth of industrial banking under Napoleon III. Availability of short-term and long-term credit through proper credit institutions and their appropriate allocation among industries played an enormously important part in economic development of France during this period (15). In Germany, industrial banks and other financial institutions also played the most important part in generating development. In underdeveloped countries, availability of credit and establishment of financial institutions are equally important to maintain the process of development. Though real factors are


(14) Relation of Money to Economic Growth, op. cit.

primary in the development of underdeveloped countries, retardation of financial development does inhibit the growth process (16).

This controversy can be resolved if the growth objective of monetary policy does not disregard economic stability. Increased money supply is necessary for increased investment. But if a part of the increased money supply is used as a basis for secondary expansion in bank credit, there is need for credit restraint to prevent rise in prices (17). For example, if a part, and an increasing part of rise in money income arising from increased investment financed bank credit is being deposited with the banks and a portion of the additions to the money supply comes back to the banks, there is increase in cash balances of the banks which augments the ability and willingness of the banking system to lend and creates secondary expansion in bank credit which may have its impact on prices. This secondary expansion in bank credit should, therefore, be restricted even though primary expansion should be allowed to continue for the sake of development (18).

Again, though increase in bank credit is necessary for increased investment, the Central Bank should guard against distortion of investment pattern. Because investments are necessary, it does not necessarily mean that all investments are good. In a period of inflationary pressure, investments may be directed to abnormal inventory building or to projects with very high profit expectations but not necessarily sound from the

long-term point of view. In such a case, credit must be made available to productive sector and denied to sectors which are unproductive. The operational methods required for achieving this result may be difficult. But it would not be correct to say that monetary restraints are injurious to economic growth.

The above analysis suggests that the fundamental objective of monetary policy should be promotion of development with stability. To increase investment, there should be extension of credit. To preserve monetary stability, the authorities should keep a continuous watch over the trends of money supply and regulate it in accordance with the needs of the economy. In other words, since stability is conducive to growth, the stability objective should be subsumed under the growth objective and attempts should be made to achieve what is called a 'controlled expansion'.

It, therefore, follows that the growth objective of monetary policy has to be sub-divided into two parts: one is the acceleration of economic development and the second is the promotion of economic stability. Since underdeveloped countries are prone to inflation, the second part implies essentially inflation control. These two parts are inter-related. For convenience and clarity, they may however be separately treated.

For the sake of growth, monetary authority should provide sufficient quantity of money appropriate to growth process. As Kindleberger has pointed out, along with economic growth, the demand for money increases for variety of reasons (19). To begin with, the extension of the money economy at the expense

of the subsistence sector requires a stock of money to satisfy
the transactions demand for money on the part of the new entrants.

Next is the increase in the demand for money for ordinary
transactions, as income per capita and the numbers of people rise.

According to Kindleberger, with no change in sophistication,
this demand will grow proportionately with total income. After
a certain stage of monetary sophistication has been reached,
it will increase at a slower rate. At a later stage of development,
again a diversification demand for money will arise.

Growth brings an increase in financial assets, as deficit
spending units (which invest) issue debt or equity securities to
surplus-spending units (which save). One of the major tasks of
the monetary authorities in development is to support the
gradual expansion and proliferation of the machinery-commercial
banks, savings banks, investment banking, insurance companies,
government bond market, private bond and share markets, etc.
which link surplus- and deficit-spending units.

It follows, therefore, that without an increasing supply
of money and credit, a growing volume of production and
investment cannot be maintained. Moreover, in an underdeveloped
country, where the non-monetary sector is large, the growth
of the monetary sector cannot be enlarged without sufficient
supply of money and credit. It may so happen that a restrictive
credit policy would force transactions out of the monetised
sector into non-monetised sector, while leaving prices within
the monetised sector as high as before. Therefore, the money
supply should grow at a rate roughly equal to that of real
income, so that prices may not fall as national income rises.

The monetary authority can also increase the growth
process by guiding flow of funds, qualitatively and quantitatively
to proper lines of investment. For example, the monetary authority can partly change the terms of trade against agricultural sector, which tends to benefit from expanded production in the secondary or tertiary sector (20). If by guiding credit, the prices of industrial goods can be increased more than the prices of agricultural goods, the scope of expansion can further be accelerated. In case of India, for instance, because the prices of agricultural goods increased more than the prices of industrial goods during the second five year Plan, there was an aggregate decrease in community saving (21). Prof. Shaw has, therefore, pointed out that credit is to be conducted to 'those channels whose aggressive spending is likely to expand real output and to guide the flow of financial assets to those whose aggressive spendings must be curtailed if the real resources of the country are to be utilised much more productively' (22).

Another important function of the monetary authority is to mobilise domestic savings for productive uses. If there are no agencies to mobilise the surplus over consumption in the hands of the public and guide it to productive channels, the rate of investment has to be reduced due to resource bottleneck. There is need, therefore, to establish banks and financial institutions in different parts of the country and create facilities for the deposit of savings in these institutions.

(20) H.N. Roy, op. cit. p.33.
At present, banks and financial institutions exist only in a limited form. The inadequacy of the development of commercial banking in India will be evident from the table given below.

**TABLE IV - 1**

<table>
<thead>
<tr>
<th>Country</th>
<th>Population (in millions)</th>
<th>No. of Banking offices</th>
<th>No. of banking offices per one million population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>8</td>
<td>3,599</td>
<td>450</td>
</tr>
<tr>
<td>Canada</td>
<td>13</td>
<td>3,323</td>
<td>256</td>
</tr>
<tr>
<td>U.K.</td>
<td>50</td>
<td>11,461</td>
<td>229</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>147</td>
<td>18,975</td>
<td>129</td>
</tr>
<tr>
<td>India</td>
<td>337</td>
<td>5,558</td>
<td>16</td>
</tr>
</tbody>
</table>

To increase banking facility, there should be more of commercial banks, savings banks, cooperative savings societies and establishment of mutual societies. Such efforts are specially needed in rural areas where facility for mobilisation of saving is almost non-existent. The surplus over consumption in rural areas in many of the underdeveloped countries is now hoarded. If the money and credit market could be extended and spread to all areas, monetary policy can play an important part in resource mobilisation.

Moreover, an extension of banking is also necessary for the proper regulation of money market. For example, a central bank cannot safeguard the currency and credit in a money market in an effective manner unless there is a predominance of commercial banks and the existence of a flexible long-term market in the economy (24). But these two conditions are absent in most of the underdeveloped countries. Thus the duty of the monetary

authority is to reduce the imperfection in the money market by creating or extending monetary and credit institutions in the country.

Then, there is the question of agricultural credit. Underdeveloped countries possess comparatively large agricultural sections, which contribute a substantial percentage of the national income. But the organisation for the supply of credit to agriculture is very unsatisfactory. Small cultivators have no financial reserves of their own and are heavily dependent on loans, but commercial banks or co-operatives have not taken any important part in meeting the needs of agriculture. In case of India, for example, the combined contribution of government and the co-operatives was about 6 per cent of the total amount borrowed by cultivators in the early part of the fifties. As for commercial banks, one per cent represented the insignificant part played by them in the direct financing of the cultivator. The professional money lenders and agriculturist money lenders dominated the scene by contributing about 70 per cent of the total credit (25). The interest charged by money lenders is 'out of all proportions to the risk involved in the business and constitute an exploitation of the helplessness, ignorance and the necessity of borrower' (26). Moreover, loans are commonly unrelated to productive purpose, many being for wasteful expenditure. As such, credit now supports the farmer as the hangman's rope supports the hanged.

(26) Report of the Agricultural Finance Sub-committee 1954, p.59 Quoted from All India Rural Credit Survey.
To improve this position, the monetary authority must reform the system of rural credit and provide the farmers with adequate credit for the improvement of productivity of agriculture at a low rate of interest. There should be large number of co-operative credit societies which could be financed by banks and the government to cater to the needs of small cultivators. So would the establishment of banks. In Cuba, for example, the government sponsored Agricultural and Industrial Development Bank has become a most important factor in promoting co-operatives through which small farmers obtain financing for crops and improvements in equipment (27). Co-operative farm credit societies have also made notable expansion in countries like Ceylon, Egypt and Turkey. The main problem in case of agricultural credit is to create new institutional arrangements to make both long-term and short-term credit at low rate of interest to small cultivators and to guarantee effective use of credit.

The monetary authority can also promote economic development by financing industries. Industries generally require long-term finance. But the traditional view is that the Central Bank and commercial banks of a country should not lock up their funds in long-term investments. Such investments again involve substantial risks. Particularly the Central Bank should abstain from such practice, because if the Central Bank undertakes the function of financing industrial development, it will render itself open to charges of discrimination and favouritism, and may become involved in political controversies. On the other

(27) Heir and Baldwin, op. cit. p.393.
hand, there are economists who feel that direct financing of industrial development by the Central Bank is indispensable (28). It would, in their opinion, remedy the problem of the existence of inadequate capital formation through the creation of forced savings in the community.

However, it seems desirable that there should be separate institutions to provide long-term finance to industries. The Central Bank can start separate departments for industrial finance like the Australian system, thereby making a clear distinction between its central banking functions and other functions or there might be separate institutions with the participation of the Central Bank, commercial banks and other financial organisations like Canada or Britain. Or both the methods can be combined. Industrial finance is indispensable for economic development and monetary authority has to play an important part for supplying necessary credit for development.

The monetary authority will not only create conditions for credit facility for the private investor, it should also meet a part of the requirements of the government finance. In all underdeveloped countries, public sector has to play an important part in generating a process of development. For this purpose, there would be three sources of finance: taxation, loans or borrowings, and deficit finance. The burden of deficit finance has to be borne by the Central Bank, the magnitude of which has to be decided carefully so that economic stability is not greatly disturbed.

The foregoing analysis shows that the monetary authority has to play an important part in the growth process of underdeveloped countries. The need for an active policy is clearly brought out in India's first five year Plan in the following words: (29).

Central banking in a planned economy can hardly be confined to the regulation of the over-all supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take on a direct and active role, firstly, in increasing or helping to create the machinery needed for financing developmental activities all over the country and, secondly, in ensuring that the finance available flows in the direction intended.

Thus in a developing economy, the monetary authority will actively participate in the growth process and create favourable conditions for fostering growth.

Monetary policy and inflation control:

Inflation control is another important objective of monetary policy. As already indicated, underdeveloped countries are prone to inflation and without inflation control, there cannot be progress with stability. It is generally thought that the power of the Central Bank to control inflation is greater than that of deflation. This is, however, not always true. Minsky has rightly observed that 'the asserted asymmetry of monetary policy (that it is effective in constraining an inflation and ineffective in constraining a depression) is not true; monetary

policy is of very limited effectiveness both in constraining an inflation and in counteracting a depression' (30). Yet the monetary authority should try to utilise its power in controlling effective demand and in the mopping up of excess liquidity to contain inflationary pressures. The three traditional instruments for this purpose are higher bank rate, open market operations and higher reserve requirements.

Higher bank rate is the most orthodox method to increase the cost of borrowing for business and consumer spending and, therefore, to restrain excess economic activity based upon borrowed funds. But if higher bank rate does not affect market borrowing, it proves ineffective in controlling inflation. If commercial banks hold a large amount of short-term government paper, they can find access to additional reserves inspite of a higher bank rate by selling some of these securities to the Central Bank or by refusing to replace maturing securities. The non-bank holders of government securities may similarly also convert their government securities into cash. This is expected more at a time when there is a rise in price, because the value of securities at that time loses much of their significance. The possession of large liquid assets like short-term or redeemable bonds is, therefore, a possible offset to high interest rates (31). Since government securities predominate in underdeveloped countries over other assets, bank rate policy has great difficulty in controlling credit. The share of government securities in case of Indian commercial banks are,for

example, preponderant. Out of the total investments of ₹389 crores by scheduled banks in the year 1953, government securities comprised ₹338 crores, which comes to 86 per cent of the total investments. The same is the story with non-scheduled banks. Out of the total investments of ₹26 crores, the investment in government securities was as high as ₹20 crores amounting to about 77 per cent of their portfolios (32). This shows that the range over which the bank rate operates is very much limited.

Again, funds borrowed for expenditure on consumption are generally meagre in underdeveloped countries, and, therefore, the reduction in total monetary demand as a result of raising the discount rate is comparatively small. The high bank rate may restrict credit in the organised sector, but consumption might continue with the funds borrowed from the unorganised sector of the money market. That means if the private demand for funds is entirely inelastic, there would be nothing to prevent a consequential differential between the interest rates on private securities and on government securities from appearing and hence nothing to check the switching of portfolios (33).

The success of the Bank rate actually depends on its influence on other short-term rates of interest (34). But if other short-term rates do not respond quickly to bank rate changes, this policy of credit control becomes a failure. In most

of the underdeveloped countries bank rate changes do not produce corresponding changes in short term rates due to the fact that in these countries commercial banks usually have excess liquidity and, therefore, do not need to rediscount with the Central Bank or borrow from it (35). Consequently, they can with immunity ignore any change in the bank rate.

In addition, Central Banks are now trying to support the price of the government bonds either to keep the interest charges on the public debt as low as possible and/or to protect the financial position of the financial institutions holding government bonds. This tendency to reduce bank rate in order to lighten the burden of the growing public debt has really made the discount rate ineffective as a method of inflation control.

Doubts are also expressed regarding the role of interest in promoting investment. Investment in the Keynesian sense includes both fixed investment as well as additions to the stocks of finished and semi finished goods. Stock holdings are more likely to be influenced by the expected behaviour of prices rather than by minor changes in interest rates. As far as fixed investment is concerned both theoretical and empirical studies cast doubts on the interest elasticity of the rate of investment (36). The withdrawal of important public utilities from the private sector and the growth of public sector are also making interest rate ineffective as an instrument for controlling investment. Another factor which makes the rate of interest a blunt weapon is the

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(35) Central Banking in Underdeveloped Money Markets, op. cit., pp. 32-38
(36) Recently some Oxford economists made a survey regarding the attitude of business men toward changing interest rates. They found that investment is interest inelastic. Only certain lines of investment like housing and public utilities were influenced by interest. Even small and medium firms did not seem to respond to the changes in the rate of interest. Out of 860 firms, for which a study was conducted less than 5 per cent seemed to have modified their investment decisions primarily as a result of the increased burden of the higher rate of interest. See H.F. Lydall, 'The Credit Squeeze on Small & Medium Firms', Economic Journal, September, 1957.
growth of monopoly and the attendant fact of the increased rate of internal financing (out of undistributed profits and depreciation reserves) of investment expenditure.

The lack of sensitiveness of international capital to changing interest rates is another obstacle to the smooth working of bank rate technique. There is now no international flow of capital due to interest changes and so the effectiveness of interest rate in promoting investment in short-term capital is limited.

The foregoing analysis shows that interest rate is not effective in controlling inflation. During the last decade, though there were upward shifts in interest rate in Great Britain, it did not also produce downward pressure on spending through the 'interest rate effect'. The Radcliffe Committee found no evidence that higher interest rates, in and of themselves, reduced consumption: there was practically no indication that interest rates were important to large firms with respect to investment in either inventories or fixed capital; expenditures of the nationalised industries were also largely impervious to changes in interest rates; the same was true for local authorities' expenditures; and spokesmen for the smaller firms treated the interest rate effect with general skepticism. The Committee, therefore, pointed out, 'It has become clear that, as the system works at present, changes in rates of interest only very exceptionally have direct effects on the level of demand (37).

The British experience is indicative of general limitations of

interest policy as a method of inflation control (38).

Open market operations have also the same difficulty in controlling inflation. The Central Bank has the power to reduce the cash reserves of the banks and thus prevent the expansion of credit by selling government securities. The success of open market operations depends on three factors i.e. the existence of a broad and active security market (or a billmarket), the maintenance of fixed cash reserve ratios by banks and the absence of rediscounting or borrowing from the Central Bank (39). Without a broad and active market for government securities, Central Bank's sale of securities on a large scale will have serious unsettling effects on security prices. The maintenance of fairly stable cash reserve ratio on the part of the commercial banks ensures that these banks will reinforce by several fold the expansive or restrictive operations of the Central Bank. Again, if banks rediscount bills or borrow from the Central Bank to replenish the cash balances that are reduced by central bank action, open market policy will be futile.

Neither of these conditions is, however, absolutely essential for the success of open market operations. If the security market is broad and active, open market operations can be carried out successfully even if banks do not maintain fixed ratios between their cash reserves and deposits (provided the fluctuations in the ratio are not very large). Alternatively if the security market is not broad and active, the Central Bank may still carry on open market operations successfully if banks maintain fixed ratios between deposits and cash reserves. In that


(39) Central Banking in Underdeveloped Money Markets, p.57.
case, a considerable volume of securities need not be unloaded or drained off the market in order to influence the reserve position of the banks. The environment becomes ideal only when all the three conditions are present (40).

The first condition is gradually developing in underdeveloped countries. Rosa thinks that if there is a large government debt and it is distributed widely among all classes of lenders and further, if lenders regard their marginal holdings of government securities as a principal source of funds for use in financing loans or investments to the private sector of the economy, the Central Bank acquires unprecedented power to influence the general availability of credit (41). In case of developed countries, this condition is already fulfilled. In an underdeveloped country like India, there is not only an increase in public debt, the preference for government security is also considerably high. But there is not yet a broad and active security market. The bill market has recently started. The facility for marketing securities is also limited. Again, the security markets do not possess the large number of dealers, or the resources, or the variety of securities which exist in the highly organised markets of London or New York. They do not also possess the capacity required for the completion of large deals within a reasonable period of time.

The second condition is also not present in underdeveloped countries. The commercial banks in India, for example, do not follow a stable cash reserve ratio. There is wide fluctuation in scheduled banks' cash ratio with the Reserve Bank.

(40) Ibid, pp. 56-57.
This limits the scope of open market operations as a regulatory device. Moreover, the commercial banks in underdeveloped countries maintain quite a substantial amount of their excess reserves in liquid assets like cash, gold and foreign exchange for the sake of security. This preference for liquidity reduces power of the Central Bank to operate in security market to control credit.

Only the third condition is favourable for open market operations. The banks have not yet got into the habit of rediscounting or borrowing regularly from the Central Bank. Yet, the conditions prevalent in underdeveloped countries show that the efficacy of open market operations is seriously limited.

Higher reserve requirements on the other hand, are more anti-inflationary than open market operations and higher discount rate. They reduce the amount of deposits in the economic system and absorb some of the excess reserves and thus prevent the commercial banks from extending credit. At least the shock effect in this case is greater. Sayers lays great emphasis upon the possible uses of variable reserve ratios in regulating credit in countries where a short-term money market is absent. He writes, 'the aggregate supply of money can be insulated from a rise in the cash basis by an appropriate rise in the legal ratios; and from a fall in the cash basis by an appropriate reduction of the legal ratios. Save for its effect on the profitability of commercial banking (and its influence should generally tend to stabilise profits and so be acceptable) there is no possible objection to this course. It is accordingly a weapon which should always be placed in the hands of a Central Bank whose technique is circumscribed by the conditions we are assuming .......' (42).

Prof. Sen also points out that this is an important instrument of control in the hands of the Central Bank (43). In fact, when the efficacy of the bank rate and open market operations is limited, a flexible minimum reserve policy can be a potent weapon at the disposal of the Central Bank for credit control.

This does not, however, mean that variable reserve ratios do not have any difficulty. If member banks possess large excess reserves as they do in underdeveloped countries, the basic legal requirement may have to be raised very high in order to attain the desired objective. Again, if ready access to reserve funds is made available by the action of the Central Bank to stabilise security prices, the restraining influence of higher reserve requirements may be limited. Commercial banks may also monetise short-term government securities as an alternative to reduced advances and thus obtain additional reserves for themselves. However, this method is more effective than the other two and can be used by the Central Bank, with proper care and precision, for effective credit control.

This method has also an additional advantage in the sense that it can be used selectively (44). If during the take off period of a backward economy, speculative investments tend to thrive, which is not unlikely, the Central Bank can increase the reserve requirements of banks involved in speculative financing. Such type of discrimination can influence the pattern of investment and channelise credit to productive activities.

(43) Central Banking in Underdeveloped Money Markets, op.cit. p.91.
This leads us to selective credit control, the importance of which has increased in recent years. When the traditional methods of credit control prove ineffective due to various imperfections in the money market and when general restriction of credit is not very helpful for economic growth, new methods should be devised to meet the situation (45). Especially when the Government is a large borrower, increased discount rate may be undesirable from the point of view of economic development. In such a situation, selective credit controls would serve a very useful purpose both for controlling inflation and for developing the economy. Moreover, if fluctuations in effective demand are centred around certain sensitive areas, and if these areas are particularly susceptible to changes in credit conditions, a decisive influence on aggregate demand may be achieved by controlling credit conditions in a few selected fields, which would minimise the need for exercising a general restraint on credit. This has become more meaningful in recent years in view of the great volume of funds involved in durable consumers' goods and real estate credit (46).

Hansen points out that in order to control cyclical booms flexible interest rate policy is inferior to selective controls. This is because in a pronounced boom, it is the speculative activities that ought to be scotched rather than the stable and sound investments. But an increase in the rate of interest hardly affects at all the high speculative ventures,

(45) Sayer points out that the cardinal virtue of the Central Banker is not conservatism in techniques but rather a disposition to discover novelties and to be versatile in technique. Vide R.S. Sayers: Central Banking After Bagehot, Oxford, 1957, p.33.

while it is likely to discourage sounder investments (47). It follows that selective controls are necessary to encourage the development of the sounder parts of the economy which might contribute substantially to a continuing prosperity.

In case of underdeveloped countries, there is greater need for selective credit control. By this method, the Central Bank can discriminate between different types of borrowers and the purposes for which they are borrowing. As a result of this, finance for speculative activities could easily be controlled and there would no restriction of funds for genuine business needs. We have seen that in underdeveloped countries there is an institutional bias in favour of investment in construction and trade to the detriment of more productive investments in industry and agriculture. To offset this bias and to encourage credit for the more productive projects, qualitative monetary controls are very useful (48).

Selective credit controls may also be useful in removing the lopsidedness of the economy. Some pockets of the economy are more backward than others. If the existing financial institutions do not satisfy the needs of these backward pockets, selective fostering of credit to these sectors may help the economy to grow.

Moreover, selective credit controls may be adopted during a period of inflation to minimise the distortion in the pattern of investment. In so far as inflationary pressures are


(48) I.G. Patel: Selective Credit Controls in Underdeveloped Countries' in I.M.F. Staff Papers, September, 1954.
generated by the speculative holding of stocks of strategic commodities like food grains by dealers, middlemen and even producers, with the assistance of bank finance, as was the experience in India towards the end of second five year Plan, any restriction on the availability of bank credit to those sectors would prevent a continuing distortion of the price level.

However, though selective credit controls are necessary, their importance should not be exaggerated in the process of development. They cannot possibly modify the investment decisions of the borrowers and lending policies of banks. They can partially control inflation arising from speculative activity in certain sensitive sectors of the economy. So far the scope of selective credit control has been limited. In Western countries, selective credit regulation has been applied mostly to the credit extended against durable consumer goods and in the U.S.A. stocks and shares, since in those economies, these are the sensitive spots. In India, however, the output and consumption of durable consumer goods, though they are rising rapidly, are still relatively of smaller dimensions. The strategic commodities in Indian conditions are mostly articles of mass consumption, namely, food grains, cloth, sugar and oilseeds. The selective credit regulations have, therefore, been operative generally in respect of advances against these commodities. Again, the selective credit regulation has been applied mainly in respect of advances to trade.

With regard to the working of selective control in India, the Reserve Bank of India is quite modest as is indicated by the following statement in the Bank's annual report for the year 1958-59:

'Selective controls are not designed to correct the general inflationary pressures within the economy nor is their success to be judged precisely by the extent to which the prices
of the relevant commodities have fallen; prices are dependent on various factors bearing on the demand and supply position of the commodities. The controls, by arresting an undue expansion of credit in the busy season and accelerating its reduction in the slack season, may be expected to exercise, only a limited, perhaps, a marginal effect, on prices, more particularly when banks have large liquid resources.

It follows, therefore, that selective credit regulations alone cannot do the job. It has to be used along with over-all credit control. In foreign countries also, the general experience has been that selective credit controls are effective only when they are operated in the frame work of overall credit restriction. Both the quantitative and qualitative controls are to be used in underdeveloped countries to achieve the object of economic growth with stability.

Working of monetary policy in India:

We have seen that the major objective of the Central Bank in an underdeveloped country is to make possible a flow of credit and money that will foster orderly economic growth avoiding inflationary instability. This was recognised by the Reserve Bank of India and the Reserve Bank of India Act was amended in 1956 in order 'to adopt the financial framework to the requirements of economic development under the second five year Plan' (49). The Governor of the Reserve Bank of India made it also clear that 'Monetary control has to accord with the objectives of the Plan and the basic policies of the government' (50).


As a matter of fact the Reserve Bank of India has taken some important measures since the beginning of the first Plan to increase the pace of economic development and to control inflation in the economy.

During the period of the Korean war boom, the Reserve Bank of India took three important measures with a view to controlling inflation and to providing adequate supply of credit for meeting the genuine requirements of trade and industry. Firstly, the bank rate was raised in November, 1951 from 3 per cent to 3½ per cent. This change was made after 16 years of stability in the discount rate. This was a signal to the banking system regarding the tightening of credit and the commercial banks, finding that there was increase in bank rate, increased their lending rates by one-half per cent, inspite of the fact that the market rates had already risen significantly during the second half of 1950 and early 1951. Thus bank rate changes influenced short-term money rates in India and restricted, to some extent, the credit expansion in the country.

Secondly, change in bank rate was supported by a suitable change in open market operations according to which the Reserve Bank declared that henceforward it would not, save in exceptional circumstances, purchase government securities from banks to meet their seasonal requirements of reserves but that it would make advances against government and other approved securities. This new restrictive policy discouraged inventory accumulation and put an effective check to the monetisation of debt that was going on in the post-war years. Thus, whereas during the period January 1948 to November 1951, the Reserve Bank had bought on its account, securities of the value of Rs.210 crores, during the period December 1951 to March 1956, it made net sales of Rs. 46 crores.
Thirdly, in January 1952, a bill market scheme was introduced in order to bring about credit elasticity in the money market. This scheme helped the Reserve Bank to meet the genuine requirements of banks for bona fide trade purposes and for short periods. For about 4 years these advances were made at a concessional rate of 1/2 per cent below the Bank rate.

These measures of monetary policy were fairly successful in the first Plan (51). As compared with increase of 18 per cent in national income, the rise in money supply with the public was of the order of 10 per cent and there was a 13 per cent decline in the general index of wholesale prices. It is, of course, true that the fall in commodity prices was assisted due to the working off of the Korean boom and increase in food production arising from favourable monsoons. But monetary policy also played some part in controlling the inflationary situation.

The inauguration of the second Plan increased economic strains in the country. To meet the situation, the Reserve Bank of India Act was amended in 1956. The amendment had two purposes: one, to strengthen the power of the Reserve Bank to fight the menace of potential inflation arising out of the enormous scale of deficit financing in the second five year Plan and second, to endow the Reserve Bank with new powers to expand the volume of credit to meet the requirements of the Plan. The proportional reserve system was an obstacle to expand the supply of credit. Accordingly the Amendment Act of 1956 empowered the Reserve Bank to create credit against a minimum reserve of gold coin and

(51) Dr. B.K. Madan: 'Monetary and Credit Policy in Relation to Planning and Development in India' - The Journal of Industry and Trade, Special Supplement, October, 1958.
bullion of the value of Rs.115 crores and of foreign securities of the value of Rs.400 crores. The Reserve Bank was also given the discretion to expand the supply of currency if the reserve of foreign securities fell at any time to Rs.300 crores from Rs.400 crores. Moreover, for achieving the gold reserve of Rs.115 crores, the Act provided revaluation of the Reserve Bank's gold and currency reserve at 2.88 grains of fine gold per rupee instead of 8.47512 grains per rupee. In 1957, the policy was further revised and the Reserve Bank of India was allowed to create credit against a minimum reserve of Rs.200 crores only. The amount of gold reserve to be maintained now by the Reserve Bank is Rs.115 crores and the remaining amount of total reserve i.e. Rs.85 crores, can be kept either in gold or foreign securities. These measures imparted elasticity to the credit structure of India.

But this power to expand credit was followed by measures to control inflation. As a matter of fact, a policy of 'controlled expansion' was adopted by the Reserve Bank of India (52). During this period, there were indications that credit extended against certain commodities especially food grains and cotton textiles (including yarn) were unduly large. In order to check advances against food grains and cotton textiles and the speculative activities, the Reserve Bank issued a directive on May 17, 1956 to banks to refrain from excessive lending against commodities in general and not to grant fresh advances or increase any existing credit limit to individual parties in

excess of Rs.50,000 against paddy and rice and to raise the existing margins in respect of loans against paddy and rice by 10 per cent.

Since 1956, the Reserve Bank has issued directives from time to time, specifying the aggregate amount of advances to be maintained by banks against paddy, rice, wheat, gram, other grains and pulses and sugar and margins to be maintained against them. Selective credit controls also extended to cotton textiles, jute goods and raw jute and also to regulation of the margin of advances against shares. These measures controlled speculative activities to a great extent though rise in prices could not be prevented due to enormous rise in deficit financing and reduced supply of agricultural commodities caused by unfavourable monsoons. In an economy where currency plays an important part, selective credit control cannot be cent per cent successful. But because selective credit controls were used with discretion and flexibility, they did not come in the way of a free flow of stocks.

Besides selective credit controls, general controls were introduced to control the mounting economic strains during the period of the second five year Plan. The rate for advances under the Bill Market scheme was raised from 2½ to 3½ per cent effective from November 21, 1956. The effective rate of these advances went up to 4 per cent from February 1, 1957 with the raising of the stamp duty on usance bills to 1/2 per cent. Simultaneously the Bank's advances rate was raised from 3½ to 4 per cent. From May 16, 1957 the Bank rate itself was raised to 4 per cent. The Bank also decided not to buy government securities directly from the banks in the busy season except in exceptional cases.
The power to alter the commercial banks' cash reserves, which the Reserve Bank acquired under the Amendment Act of 1956 extended further the latter's control over the commercial banks. Prior to the amendment, the scheduled banks were required to keep minimum reserves with the Reserve Bank at fixed ratios, namely 2 per cent against time liabilities and 5 per cent against demand liabilities. The amending Act enabled the Bank to vary the ratio from 2 to 8 per cent in respect of time liabilities and from 5 to 20 per cent in regard to demand liabilities. The Bank actually used it for the first time in March 1960. This method of freezing a proportion of additional deposits restrained unwarranted increase in credit. To reinforce the general and selective credit controls, moral suasion was often used. The Governor of the Reserve Bank has, through conferences with and letters to banks, advised them to follow cautious lending policies. The Banks generally followed these instructions and acted upon the advice of the Governor of the Reserve Bank.

The foregoing analysis shows that the Reserve Bank has used its power discreetly and effectively to control the inflationary forces of a developing economy. It is true that during the second Plan period, there have been increase in commodity prices and substantial decrease in foreign exchange reserves. They do not, however, necessarily mean that monetary policy has been ineffective. The dimensions of the forces making for imbalance in the economy have been large and complex - large budgetary deficits and marked fluctuations in agricultural output, to mention a few. The fall in exchange reserves was largely a deliberately planned one, to finance the large volume of investment which is being undertaken. In such an environment, Reserve Bank could not possibly remove inflationary
pressures. It could, perhaps, be said that monetary policy has at least helped restrain the growth of inflationary pressures inherent in a rapidly growing economy. Certainly, it has not led to aggravation of inflationary conditions (53).

**Credit for economic development:**

If monetary policy has to promote development, it shall not only control credit, it must also provide sufficient credit for economic growth. For the purpose of development, the Reserve Bank of India has created new channels to finance agriculture and industry. Till recently, attempts of the Reserve Bank at agricultural finance were inadequate, indirect and roundabout. The Bank did have a separate Agricultural Credit Department, but its function had been primarily one of research and inspiration rather than the actual financing of agriculture (54). Since the beginning of the first five year Plan, systematic attempts have been made to reorganise rural credit on scientific lines. Reference has already been made to the inauguration of the Bill Market Scheme in January 1952 for providing an elastic source of credit to the commercial banks. Few aspects of the Bank's operations have been so striking as the contribution which it has made to the promotion of an institutional system of rural finance, the Bank's responsibility in this field being enjoined on it by its statute and occasioned by the predominantly agricultural basis of the Indian economy. In the year 1951, the Bank organised a comprehensive All India Rural Credit Survey under the supervision of a Direction Committee.


The Committee recommended for the setting up an integrated structure of rural credit, marketing and processing on a co-operative basis, with the State as financial partner wherever necessary. There was also special emphasis on the need to build up an adequate corps of trained workers to look after the needs of rural population. The Reserve Bank of India was also assigned an important role in this integrated credit.

On the basis of these recommendations, the State Bank of India came into existence on July 1, 1955 to take over the assets and liabilities of the Imperial Bank of India. The important objectives of the State Bank have been the provision of credit facilities, mobilisation of rural savings and development of banking habit through a concerted programme of expansion of branches. The Bank has started taking increasing interest in rural credit. It has decided to make advances to co-operative banks against government securities and to collect bills at a concessional rate on behalf of co-operative banks in centres having no branch of a State or District Co-operative Bank. The State Bank is also providing assistance to Land Mortgage Banks which are engaged in long-term finance. Attempts are also being made to bring about close coordination between State Bank and co-operative banks by appointing the agencies of State Bank at the district headquarters as ex-officio directors of the district central co-operative banks. The Bank has already opened 400 branches within the first five years of its existence and hopes to get another 145 branches before June, 1965.

Besides the establishment of the State Bank of India, two National Agricultural Funds have been set up by the Reserve Bank to finance agriculture. The National Agricultural Credit
(Long-term operations) Pond was set up on February 3, 1956 with an initial contribution of Rs.10 crores with a view to providing long-term finance to agriculture. The National Agricultural Credit (Stabilisation) Fund was set up on June 30, 1956 with a contribution of Rs.1 crore. The main purpose of the Fund is to provide medium term loans and advances to State Co-operative Banks to enable them to convert their short-term credit into medium-term credit whenever it is necessary as a result of drought, famine or other natural calamities. Both these funds are being supplemented by further grants from the Reserve Bank of India and they are now doing very useful service in providing direct finance to agriculture. As a result of these provisions, the grant of loans to co-operative banks is rising rapidly. As compared to the sum of Rs.3.15 crores in 1950-51, the short-term advances have risen to Rs.115 crores at the end of 1961-62. These advances have been made at a concessional rate of 2 per cent below the Bank rate for financing seasonal agricultural operations and marketing of crops. Medium-term loans sanctioned by the Bank to State Co-operative banks, out of the National Agricultural Credit (Long Term operations) Fund, for agricultural purposes have increased to Rs.11.7 crores at the end of 1961-62, as against Rs.22 lakhs at the end of 1954-55. In addition, the Bank also sanctioned medium-term loans to State Co-operative Banks at the Bank rate for advancing, through Central Co-operative banks and societies affiliated to them, loans to small and medium cultivators to enable them to purchase shares in co-operative sugar factories. The Reserve Bank also subscribed to the debentures floated by central land mortgage banks (54).

The Reserve Bank is not only helping the State Governments and the Central Government to establish Co-operative institutions, it is also trying to improve the efficiency of these institutions through a process of inspection. Provision is also made for giving training facilities for co-operative personnel. Another notable development in strengthening the co-operative system is the opening of four regional offices of the Agricultural Credit Department of the Bank, one each at Bombay, Calcutta, Delhi and Madras with effect from April 15, 1957. The regional offices have initially been entrusted with the inspection of co-operative banks functioning within their jurisdiction.

Finally, Warehousing Corporations have been established in accordance with the recommendations of the All India Rural Credit Survey and the Reserve Bank has been empowered to make advances and loans to these Corporations. The Central Warehousing Corporation established warehouses at 22 centres during 1961-62, bringing the total number of warehouses established by it so far to 62. The State Warehousing Corporations opened 107 warehouses during the year to bring the aggregate number of warehouses established by them up to the end of June 1962 to 374 (55). All these provisions have given direct responsibility to the Reserve Bank to take initiative in agricultural finance and it is hoped that this would enable the Reserve Bank to organise agricultural finance on a sound footing.

**Industrial finance**

In the field of industrial finance, the Reserve Bank is also playing an active role. In the year 1948, the Bank played an important part in the establishment of the Industrial Finance Corporation and contributed 20 per cent of the total issued capital of that institution. Since 1952, the Corporation

has also been authorised to borrow funds up to Rs. 3 crores from the Reserve Bank against specified types of securities for a maximum period of 18 months.

The Industrial Finance Corporation is designed to purvey medium and long-term credit to large-scale industries. Since its inception in July 1948 up to the end of June 1962, the Corporation had approved loans for a total of Rs. 130.3 crores, of which Rs. 68.1 crores were disbursed (56). A part of this loan was also in foreign currency. The Reserve Bank has also taken initiative in establishing State Financial Corporations for the provision of medium and long-term credit to small and medium industries. The contribution of the Reserve Bank towards the issued capital of the different State Financial Corporations has varied between 10 and 20 per cent.

Since their inception up to the end of March 1962, the State Financial Corporations have sanctioned loans and advances for an aggregate amount of Rs. 49.1 crores, of which Rs. 30.2 crores have been disbursed (57). The State Financial Corporations Act 1951 has been amended in March 1962 and the scope of the activities have been further increased.

The Industrial Finance Corporation and State Financial Corporations were designed originally to provide only loan capital and were thus not in a position to meet all the requirements of development finance.

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(56) Ibid, p. 1396.
(57) Ibid, p. 1396.
It was necessary to create an institution to develop the capital market by stimulating the supply of risk capital through subscriptions to as well as underwriting the issues of joint stock companies. The Industrial Credit and Investment Corporation of India was accordingly set up in 1965 in collaboration with the International Bank for Reconstruction and Development. This Corporation has been the pioneer in securing foreign exchange loans from the World Bank and foreign countries and has been able to, in turn, make foreign exchange loans to its borrowers. The total financial assistance sanctioned by the Corporation since its inception up to the end of 1961 was Rs.42.7 crores, of which Rs.18.4 crores, were disbursed. Of the Rs.42.7 crores sanctioned, Rs.29.6 crores represented loans and guarantees, Rs.10.2 crores underwriting of ordinary and preference shares and debentures and the balance of Rs.2.9 crores direct subscription to ordinary and preference shares. Of the Rs.29.6 crores sanctioned in the form of loans and guarantees, the share of foreign currency loans was Rs.19.4 crores or 65 per cent (58).

Recently the Bank has actively participated in establishing a Refinance Corporation to provide relending facilities to banks against medium-term credit granted by them for the medium-sized industrial units in the private sector. The genesis of the Refinance Corporation was one of the terms of the Agricultural Commodities Agreement under P.L. 480 signed in August 1956 by the Government of India and the Government of the U.S., whereby a sum of $55 million dollars was earmarked for relending to private enterprise through established banking facilities. Since its inception in June 1958, the Corporation received 149 applications for Rs.26.2 crores and the amount

sanctioned was Rs.20.5 crores, of which Rs.10.1 crores were disbursed (59). There is marked expansion in the business of Refinance Corporation due to operation changes introduced in 1960-61.

Since small-scale industries have a special place in the development plans of India, there is need to extend credit to this sector. With this end in view, the Reserve Bank of India administered a credit guarantee scheme on behalf of the Central Government. Under this scheme, a degree of protection was conferred on approved financial institutions against the risk of loss on short and medium-term advances made to small-scale industrial units. The guarantee scheme was initiated in July 1960 and within two years the guarantee organisation has issued guarantees exceeding Rs.10 crores. Besides, State Bank has also agreed to provide medium-term advances to small-scale industries. A scheme was finalised in 1960-61 for granting reasonable amounts of medium-term advances upto 7 years to small-scale units, which were obtaining their working capital needs from the bank, to meet the cost of modernisation, expansion, replacement etc. The State Bank also entered into an agreement with the National Small Industries Corporation under which the latter authorised it to finance upto 100 per cent of the value of raw materials pledged as security by small industrial units which secured orders through the Corporation.

The establishment of separate institutions by the Reserve Bank for providing industrial and agricultural finance augurs well for the sound monetary management. There is no possibility that these institutions would aggravate inflationary pressure in the economy. On the other hand, they will directly assist in the building up of the economy and increasing the

production of necessary goods and services. It is a happy
sign that the monetary authority in India is changing from a
mere regulatory one 'to a regulatory and development one'. The
restrictive tone of the monetary authority cannot be neglected
as long as inflationary pressure is present in the economy.
But that does not mean that the developmental aspect of credit
and monetary policy should be neglected. Both are correlated
and one cannot be successful without the use of the other. It is
good that a start has now been given in both the directions.

Summary andConclusion:

The foregoing analysis shows that the Banking system
in India is now doing valuable service for the economic
development of the country. Banks are venturing into certain
lines which were traditionally not considered as a part of
commercial banking functions; the spurt in recent years in the
underwriting of new issues, the expansion of formal term loans
to industries, issue of guarantees for deferred payments
agreements between Indian business firms and foreign collabora-
ting firms are but a few illustrations. Industrial advances of
banks today form 54 per cent of the total bank credit as
against 33 per cent less than a decade ago (60). The establishment
of the Export Risks Insurance Corporation in 1957 and the wide
range of risks covered by this Corporation have facilitated
the grant of credit by the banking system in those situations,
where exporters were previously unable to secure credit
facilities.

(60) Speech of Sri P.C.Bhattacharyya, Governor, Reserve Bank
of India on June 26, 1962, to the trainees of the Staff
Training College of the State Bank of India at Hyderabad -
In recent years the banks have also made considerable progress in deposit mobilisation. During the first Plan period, the deposits of scheduled banks rose by Rs.130 crores or by 3 per cent per annum. During the second Plan period, these figures were stepped up to about Rs.600 crores or an annual average of 12 per cent. For the financial year 1961-62, there was a rise of over Rs.200 crores or 13 per cent and that order of growth continues by and large (61). The establishment of the Deposit Insurance Corporation on January 1, 1962 with a view to giving a measure of protection to depositors, especially small depositors, against the risk of losing their savings in the event of a bank's inability to meet its liabilities will assist banks in further mobilisation of deposits.

However, the potential effectiveness of monetary policy as a means of promoting capital formation should not be overestimated. Though there has been considerable improvement in the banking activity in recent years and the Central Bank is gradually spreading its influence to different markets, monetary policy is not yet sufficiently developed to mobilise adequate resources for economic development or to effectively control inflation. The Indian money market is more developed than the money markets of many other underdeveloped countries. Yet in India, there are some peculiar features which impede the effective use of monetary policy.

For example, monetary policy for its success depends upon institutional factors like the use of credit, credit consciousness and their preferences, the general banking structure and development and banking habits of the people as a whole (62).

An advanced economy is highly responsive and flexible and any impulse in an economic organ is transmitted smoothly and effectively throughout the economy without any institutional inhibitions. Such is not the phenomenon in an underdeveloped country where the type of impulse is impeded at every step by rigidities and inelasticities that characterise a backward system of production and exchange (63). The following features of the Indian money market may be cited as illustrations to show the peculiarities of an underdeveloped economy.

To begin with, the Indian money market consists of two parts. The first part is dominated by the banking system and the second part which occupies a more important place in relation to the total resources of the country consists of shroffs, sahukars, money lenders and other indigenous bankers. This vast sector of the money market is unorganised and it functions outside the orbit of the organised monetary system.

The organised sector does not meet more than 50 per cent of the total demand for funds from trade and industry. Agriculture which is the most important occupation of the people of India is largely financed by the unorganised money market. This increases the degree of diversity in internal arrangements and creates serious problems for the Central Bank.

Again, the preponderance of unregulated agencies for supplying credit leads to wide divergence in rates of interest (64). There is no competition in the determination of rates of interest; it is settled by convention, custom or agreement.


(64) Vide The Report of the Rural Credit Survey, op.cit. In some places the rate of interest approaches 300 per cent. The Pathans, Kabulis and Rohila money lenders charge from 75 per cent to 360 per cent.
Even in the organised money market, there is a great difference in the loan rates of different banks. The simultaneous existence of interbank call money rate of 2 per cent, a hundi rate of 4 per cent, a bank rate of 3 1/2 per cent, a Bombay Bazar rate of 5 per cent and Calcutta bazar rate of 6 per cent shows a substantial immobility of money and credit in different money markets in India and leaves little room for the success of monetary policy in India.

The utility of the banking system is further circumscribed by the fact that within the monetised sector, the means of transaction is mostly currency, and not bank deposits. Where the bulk of the circulating medium is currency, it is extremely difficult to exercise any qualitative or quantitative control over monetary demand. The proportion of currency to total money supply, which was 66.9 per cent in 1951 remained about more or less the same level over all these years. Rather, the percentage was slightly higher at 69.6 per cent at the end of 1959. In the year 1955-56, it became as high as 73.2 per cent. According to the Reserve Bank of India this proves that the increase in incomes due to disbursements made by the government has been accruing to those classes of people among whom the banking habit is not developed.

The preference for liquidity is so great that even cash and notes are used for the purpose of store of value. This predominance of currency over credit leads commercial banks to maintain large margins over and above the statutory minimum and the availability of such surplus cash makes for reduced dependence on the Reserve Bank of India.

The direct results are, first, a relatively restricted use of credit; second, the direct employment of cash for a
large part of monetary transactions; and third, which follows from the second, the consummation of transactions in kind i.e. in non-monetary terms. Super-imposed is the hoarding habit, which to quote J.S.C. Wilson "appears to provide an almost bottomless pit for the absorption of gold and silver" (65).

Then there is underdevelopment of capital market. The development of a well-knit and integrated capital market is essential for the effective use of the machinery of Central Banking. Without a developed capital market, the surplus resources of the people cannot be mobilised for increasing investment in the country. As already indicated, saving in an underdeveloped country is low due to low level of income. And again, there is a lot of misdirection in savings due to lack of banking institutions and conservative nature of the people. According to the study of the U.N.O. hoardings in forms of gold and currency form about 10 per cent of the national income in countries like South and South East Asia and Middle East. If we could develop a capital market and properly integrate it with different banking institutions, we could possibly increase the free flow of resources from one area to the other and prevent this type of misdirection of scarce resources.

According to Plumpter, a capital market is underdeveloped if it has the following characteristics: (66).

(a) The rate of interest and the rate of exchange are determined more by convention, custom or agreement and much less by competition.

(b) There is not a sufficient degree of breadth and liquidity in the markets to satisfy the normal needs of the individuals and institutions concerned.

(65) Quoted from H.M. Roy, op.cit. p.67.
(66) A.F.W. Plumpter, 'Central Banking in the Dominions' Toronto, 1940, pp.4-5, Quoted from D.R.Khatkhate, op.cit. p.39.
(c) There is export rather than import of capital and the institutions in the market depend upon some foreign market as the repository of their liquid funds.

All these conditions of underdevelopment are present in India. The wide variation in rate of interest and lack of competition in money market have already been discussed. The situation with regard to determination of rate of exchange is not different from this. The security market is also equally imperfect. The limited number of securities prevents the security holders to make a wide choice in dealing with them. Again, the securities are also less liquid as expectations are not very stable and reliable in underdeveloped countries. Finally, the importance of foreign banks and the dependence of Indian banks on London money market reduce the finance available for local needs and consequently, internal trade, commerce and industry are grievously handicapped.

All these difficulties of the money market (67) reduce the importance of the Central Bank in an underdeveloped country to control inflation. Moreover, the capacity of the monetary authority to develop the economy is also exceedingly narrow. The monetary authority can, of course, channelise savings by creating new institutions. But the problem of inadequate savings cannot be solved only by creating new institutions. The growth of saving depends basically on an increase in productive power and a rise in national income, so that the

(67) Many other difficulties can also be added to these mentioned above. The prevalence of barter economy, absence of trade-banking pattern and the conservative nature of commercial banks in financing industries are no less important in reducing the importance of Central Bank to control inflation.
proportion of the national income that can be saved will grow (68). An easy money policy makes credit more readily available, but this credit will not be utilised unless profit expectations are sufficiently high. On the other hand, this will only feed inflation which considering the costs of inflation, is an undesirable means of forcing saving (69).

Even Wittlesey who pleads for development objective of monetary policy admits that 'Central bankers are not temperamentally suited to administer economic growth as a monetary objective. It is nature of bankers, including central bankers, to be conservative rather than adventurous. But economic growth is essentially an adventurous conception. It does not fit into the comfortable mechanical scheme of things' (70).

It follows from this that monetary policy cannot be expected to be the primary and active mover of development in a backward economy. As a matter of fact, as a means of promoting capital formation, monetary policy is of secondary importance compared with fiscal policy. Therefore, though every instrument must be pressed into use to the best advantage in the service of development, the limitations of monetary policy should be borne in mind and greater emphasis should be laid on fiscal policy to promote economic development. However, for the successful working of fiscal policy, monetary policy should be geared in such a manner that it would not counteract fiscal measures undertaken by the government for the purpose of development.

(68) Meir and Baldwin, op. cit. p.394.
(69) Ibid, p. 394.
(70) Relation of Money to Economic Growth, op. cit.