CHAPTER I

THEORY OF MONETARY POLICY

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Introduction

There is probably no field of economics in which the writings of economists are so strongly influenced by both current thought and current problems of economic policy as the field of monetary policy. In the post-war periods, economists generally regarded monetary expansion as a measure to stop depression. But whether control of money supply is an effective weapon to control inflation or not, was very much sceptical. Some economists took the extreme view and thought monetary restraint to be completely ineffective. But it was generally thought that the wartime legacy of a large and widely-held public debt was a major obstacle to the application of monetary restraint.¹

The post-Korean war inflation forced the termination of bond-support programme, and thereafter monetary policy became the chief instrument of controlling short run fluctuations. The availability doctrine of monetary policy has left its mark on the field, in as much as the majority of monetary economists would probably explain how monetary policy influences the economy by reference to its effects on the availability and cost of credit.

This idea was cherished in the pre-Keynesian period also, when monetary policy was the single established instrument of aggregative economic policy, and price stability was its established objective. Keynesian

economics brought in its wake the idea of fiscal operations and the objective of economic stability by maintaining full employment.

Role of money supply was viewed differently by different schools of thought. The classical economists did not place much emphasis on the role of money in determining the course of economic activity. Its effect was only to cause an equiproportional change in prices. Money was thus a passive factor in the basic functioning of economic system. Its effect was felt on prices alone and this was the chief reason why it was regarded important.

Such a belief in the classical dichotomy could not be dispelled even by subsequent developments in the classical monetary theory. The credit for bringing money as a factor in economic analysis really belongs to Keynes. As Professor H.G. Johnson has observed, "the fundamental contention of Keynesian monetary theory is that a monetary economy is essentially different from a barter economy—that money is not merely a veil but exercises an influence of its own in the working of the economy."\(^2\) Keynes showed how money supply affected interest rate through liquidity preference and how interest rate in turn affected investment and economic activity.

**The Present Study**

The present study is not concerned with the methodological controversy regarding the effects of money supply.

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It is concerned with the basic question as to whether prices change with the change in the money supply. Keeping in view the objectives of monetary policy (price stability being the most important) an attempt shall be made to formulate an appropriate monetary policy to control inflation.

The basic objectives of the present work are:

i) to establish the thinking that money supply affects price level;

ii) to study the extent of association between these two key factors in the economy; and

iii) to suggest some monetary measures to control inflation.

Plan of the Study

The work has been divided into three parts. The first part deals with the theory and practice of monetary policy. Theoretical implications of monetary policy and their execution in the Indian context has been studied in this part. The second part is concerned with the theory and practice of inflation. Inflation in India has been analysed keeping in view the developments in the theory of inflation.

In the third part, an attempt has been made to study money supply and inflation jointly assuming that money supply is the cause of inflation. On the basis of theoretical association between the two, their relationship has been studied statistically. The study ends with two Appendices, one containing some detailed statistical information and the second contains bibliography.
The work is a combination of theoretical and quantitative research. The tools for the quantitative analysis have been based upon their theoretical nature. The statistical data has been collected from two sources namely, The Reserve Bank of India though its monthly bulletins and annual reports on Currency and Finance; and the Central Statistical Organisation.

The period of study has been determined by the need to analyse monetary experience in the context of economic development and by the availability of reliable data. The period of planned development started from the year 1951-52 when the First Five Year Plan was launched and it has continued since then under successive Five Year Plans, but for a brief spell of annual plans. The last year for which figures are easily available at present is 1974-75. Thus, our period of study stretches from the financial year 1951-52 to 1974-75.

This gives twenty-four yearly observations which may be considered adequate for the correlation method used in this work. Number of observations could have been increased by including the observations before 1950-51. This would have raised the difficulty of getting the relevant and reliable statistics. It would also have made our period of study less homogeneous by including the abnormal years of war and post-war period. The number of observations may also be increased by making use of quarterly or monthly figures. This is not possible as some of the figures like those of national income are
available on an annual basis only. The use of annual data has prevented us from considering the possibility of lagged relationships between different variables since a year is an unduly long unit for studying lags.

This is primarily a static equilibrium analysis. The main object of our enquiry is to explain the mutual relationship and the extent of association between two economic variables, namely money supply and prices, and not to give an outline of the dynamic adjustment process.

The Theoretical Framework of Monetary Policy

Monetary policy and monetary theory are related to each other. Monetary theory provides a groundwork for the monetary policy. Thus, before discussing various issues of monetary policy, we must discuss briefly monetary theory in general and its development and refinements through the contributions of different economists.

Monetary theory may be defined as the combination of "the theories concerning the influence of the quantity of money in the economic system, and monetary policy as policy employing the central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy."³

Monetary theory before the Keynesian revolution was concerned primarily with the theory of the price levels, the determination of the general level of prices.⁴

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The behaviour of monetary theory is so important that it must be studied by anyone who would be interested in the actual working of the economic system. This branch of economics, the behaviour of money and its interrelations with the functioning of the economy is usually referred to as monetary theory. The major jobs of monetary theory are to define and explain the behaviour of money and its interrelations with the functioning of the economy. The contents of monetary theory cannot be described specifically as they depend upon individual's belief as to the nature and extent of these interrelations.

Whatever might be the contents of monetary theory, one fact cannot be denied that money has a pivotal role to play in the framework of monetary theory. At the same time, it must not be too hastily concluded that because money is employed in such a large proportion of economic activities, it exerts an independent influence on the functioning of the economic system.

The description of money as a passive servant is owned by the classicals, for whom "the mere introduction of a particular mode of exchanging things for one another by first exchanging a thing for money, and then exchanging the money for something else, makes no difference in the essential character of transaction." They stressed the importance of money only as a medium of exchange.

5. Ibid., p.17.
The significance attached to monetary theory declined as compared to its offshoots like business cycle theories and fiscal theory. This decline can be attached to the experiences of the 1930's, the intellectual impact of Keynes' General Theory, and the inhibiting effects of the wartime expansion of public debt on monetary policy. Even then, the contributions in the field of monetary theory have been quite significant in recent years, which signify its growing importance in the context of public policy in general and economic policy in particular.

To study a few developments in the monetary theory, the issues raised by Keynes' attack on classical monetary theory have been worked over with the apparatus of general equilibrium analysis developed by J.R.Hicks, and Keynes' emphasis on treating money as an asset has been followed by subsequent theorists as a means of bringing money within the general framework of the theory of choice. In larger part, the revival of interest in money is a reflection of external developments—the postwar inflation, the revival of monetary policy and the persistence of inflation in the face of unemployment.

The interest of the professional economists in these matters has led to large scale enquiries into monetary policy and institutions. Notable among these enquiries are the Radcliffe Committee Report in Britain, Report of the


Commission on Money and Credit in the United States,\(^9\) and some other works stimulated by the availability of new data—especially Raymond Goldsmith's data on saving and financial intermediaries in the United States,\(^10\) the Federal Reserve System's flow-of-funds accounts\(^11\) and, Milton Friedman and Anna Schwartz's historical series of the United States money supply.\(^12\) One significant development in the theory of money has been the controversial "Classical Dichotomy" and the concept of neutrality of money, which helps in formulating the objectives of monetary policy.

During the present century, by far the greatest performance, in the analytical monetary analysis, is that of Walras.\(^13\) His theory of money and prices is simply a part of his general theory of economic equilibrium. He fulfilled the long-cherished desire that the analysis of money should be built into the system of general theory instead of being developed independently and then plastered upon it.\(^14\) So far as monetary statics is concerned, all propositions developed about money and monetary processes are either contained in his system or may be derived from

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it by introducing additional assumptions. As has been said by Lange,\textsuperscript{15} the Keynesian analysis of the General Theory is but a special case of the genuinely general theory of Walras.

Another original work on money, related to that of Walras, was that of Irving Fisher,\textsuperscript{16} Ever since the publication of his book, Fisher has been classed as a sponsor of a particularly rigid form of quantity theory.

The second great performance of the last three decades of the nineteenth century was Marshall's.\textsuperscript{17} Like Walras, he saw the monetary problem as part of the general analysis and as one of the doors to the theory of employment. He thought about the importance of the distinction between the 'real' and the 'monetary' rate of interest and the mechanism by which money supply affects economic system. As a matter of fact, all the economists at Cambridge after Marshall, developed what Marshall said in a crude form.\textsuperscript{18}

Before the classical school of thought, economic ideas were very stray. Upto the nineteenth century, many economic ideas were knit together to give us a complete economic theory—called classical economics. Within the

\begin{itemize}
  \item \textsuperscript{16} Irving Fisher, \textit{The Purchasing Power of Money}, London, 1911.
  \item \textsuperscript{17} Alferd Marshall, \textit{Money, Credit and Commerce}, London, 1923.
  \item \textsuperscript{18} English Monetary theories developed in the present century by Havtray, Lavingstone, Keynes, Pigou and Robertson are on the teachings of Marshall.
\end{itemize}
framework of classical economics, monetary theory was dealt with as a part of the whole theory. Classicalists tried to link the monetary theory with the rest of the economic theory. But classical monetary theory was not directly linked with the level of employment. The classical theorists assumed a tendency to full employment of the economic system, as a consequence of flexibility of wages and prices. They did not place much emphasis on the role of money in determining the course of economic activities.

Money was considered to be a catalyst. It did not affect such real quantities, as savings, investment, the rate of interest and the volume of real output. Its effect was only to cause an equiproportional change in prices, money costs and hence in money value of profits without affecting the rate of profit or the long-term rate of interest.19

This argument of the classicals had many serious flaws. The realisation that this approach rested on unrealistic assumption, led some of the classicals themselves to utter a note of dissent.20 These dissidents (like Bentham and Malthus) foresake the concept of 'neutral money' and developed a more celebrated doctrine of "forced saving." The essence of this doctrine is that an exogenous increase in the quantity of money which accrues initially to entrepreneurs or to those who lend to them,


The link between money supply and capital formation was very much emphasised by Schumpeter in his theory of economic development. But, however, important the doctrine of 'forced saving' might have been, it could not dispel the belief in the classical dichotomy of real and monetary forces.

The Classical Dichotomy

One of the most fundamental objections raised by Keynes in his General Theory, was the validity of the classical Dichotomy, the traditional separation of monetary and value theories. According to this dichotomy, the relative price level is determined by the real forces of demand and supply and the absolute price level is determined by the combined forces of the quantity of money and its velocity of circulation. This dichotomy, perhaps, was
the result of the classical assumption that the demand and supply functions for commodities are homogeneous, of degree zero, in commodity prices, (which means, a doubling of all commodities' prices will leave quantities demanded and supplied unchanged—in other words, quantities demanded depend only on relative prices).

Don Petinkin's criticism of the Dichotomy was stronger, when he said that there was a logical contradiction between classical value theory, in which demands and supplies of commodities depended only on relative prices and not on the real value of people's cash balances, and the quantity theory of money, in which the dependence of spending on the real value of money balances provides the mechanism by which the quantity of money determines a stable, equilibrium absolute price level. 26 Petinkin removed this dichotomy by suggesting a link between the demand and supply functions and the real cash balances. 27

Petinkin in his monumental work, cited above, develops a full theory of the real balance effect. The effect has been developed in terms of a Hicksian exchange economy. A rise in prices lowers the real value of an individual's initial cash holding and provided that neither goods nor real balances are inferior, reduces his demand for both. But a proportional rise in prices accompanied

26. Don Petinkin, *op cit*, p. 188.
by an equiproportional increase in the individual's initial stock of money does not alter his behaviour.

The Neutrality of Money

Don Petinkin arrived at another important conclusion that relative prices and the rate of interest are not affected by the quantity of money. This neutrality of money was established as a result of many significant assumptions (later became important theories) like wage-price flexibility, absence of money illusion and absence of distribution effects. These assumptions have strongly been criticised by J.G. Gurley & E.S. Shaw whose purpose is to elucidate the conditions under which money will not be neutral.28 They accept the possibility of rigidities, money illusion, expectations and distribution effects, being quite important. But they developed their model excluding the assumptions underlying Petinkin's model. In their model, money is an inside money.29 In this model the price level is determinate and money is neutral. They show that money will not be neutral in a system containing "inside money" and "outside money".30 Also that the appropriate test of neutrality is an equiproportional change in inside money.

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29. When money is not itself government debt, but is issued by monetary authority against private debt.
30. Opposite to Inside Money.
Definition of Monetary Policy

 Monetary Policy is as old as monetary system and money itself. There are evidences which suggest that even in ancient period, monetary management was known in Greece. The prince who minted the first coin was a monetary reformer and the princes who debased their coins to finance deficit were also monetary reformers. "Managed currency was not entirely unknown to the ancient Egyptians, Greeks, and Chinese, who shifted bullion to and from the shrines of their temples in order to counteract movements in the price level."31 But, before 1914, the whole thinking about monetary policy was based upon the idea of automatic gold exchange system.

 During the World War I (1914-1918), this notion was almost shattered, and monetary policy assumed new dimensions. In the modern sense, monetary policy aims at a systematic regulation of the volume of money (currency as well as credit) with a definite objective in view. Monetary policy should be able to work both ways—forward as well as backward. Irrespective of the objectives of monetary policy, it has attained a definite dimension, in which it works. The objectives of monetary policy generally revolve around expansion or contraction of credit. It implies a positive endeavour to regulate the volume and value of currency and credit in a way that is considered

to be in accordance with the interests of the increase of
the welfare of the community, independently of the technical
international considerations which had been, in the past,
regarded as being of paramount importance.

The genesis of monetary policy took place after
the World War I, when the gold exchange standard showed a
break-down. Inflation in Germany in 1920, and two inter-
national conferences, in 1920 in Brussels and in 1922 in
Geneva, compelled the statesmen in the world to think
about a new monetary system, which was bound to effect
the monetary policy in every country. Before that, as
has already been stated, automaticity of gold exchange
system was cherished, because of which the idea of
central banking was nebulous. In due course, the return
of Great Britain to the gold standard was hailed as giving
a lead in the great work of monetary reconstruction. But
this was only the beginning of a herculean task. At the
time, "scarcely anyone considered that the price level
could or ought to be the care and pre-occupation, far
less a main objective of policy" of a central bank.32
Increasing unemployment was a reminder to the world that
the monetary problem, that of providing and working a
thoroughly satisfactory currency and credit machine, cannot
be solved easily and finally before a distant future. The
depression of the thirties provided further stimulus to the
thinking of reforms in the field of monetary management.

32. Report of the MacMillan Committee, Cambridge, 1930,
para 276.
In the recent past, the horizons of monetary policy have further been widened greatly. The central bank of a country has to decide whether to maintain or to change the terms on which it is prepared to grant credit; exchange control authorities have to take action day by day and hour by hour; banking leaders and treasury officials have to be in constant touch with each other to consider the questions that arise daily.

To define monetary policy in specific terms, it is the control of availability, cost and the use of money and credit. The traditional agent of monetary policy is the central bank, which works through the monetary system. More or less, it deals with the monetary system of a country. It may have been defined in different words by different monetary economists, but all of them testify its concern with the measures and decisions of a monetary nature.

Dr. Paul Einzig brands the monetary policy as "the attitude of the political authority towards the monetary system of the country under its control." Geoffrey Crowther defines monetary policy as the steps taken to reduce to a minimum the disadvantages that flow from the existence and operation of the monetary system. The definition given by Geoffrey Crowther clearly envisages the disadvantages of the monetary system and avoidance of such disadvantages from the monetary system can safely be called a passive monetary policy. An active monetary policy

can be defined as a step or a number of steps taken by the
monetary authority to promote the economic welfare of the
economy as well as social sense. A blend of these two
actions can be termed as the ideal monetary policy. To
quote Paul Einzig again, monetary policy should aim at
increasing the advantages and reducing the disadvantages
that flow from the monetary system. 35

Monetary policy can be defined from another point of
view also. "All monetary decisions and measures irrespec-
tive of whether their aims are monetary or non-monetary,
and all non-monetary decisions and measures that aim at
affecting the monetary system", 36 constitute monetary
policy. In this category will be included the steps
taken for influencing the value and volume of money and
the monetary measures which pursue non-monetary, economic,
social or political aims. Monetary measures like debase-
ment, inflation, deflation and devaluation etc., and non-
monetary measures like price and wage controls, physical
controls, budgetary devices, export drives, import cuts,
quota system etc., will all come under monetary policy
because they aim to influence the monetary situation in a
country.

It is imperative to distinguish clearly between
various allied policies. Monetary policy is a close ally
of fiscal policy and banking policy. The relationship
between these is so close that often monetary policy and

banking policy are taken as one whereas fiscal policy is considered as an end or means of monetary policy. They may be complementary and sometimes it may be difficult to draw a line in-between, still they are different.

Fiscal policy mainly refers to the measures taken through the mechanism of budget. It deals with the revenue, expenditure, borrowing, debts redemption etc. The operations of these items as well as the relationship among these, form the core of fiscal policy. But fiscal policy cannot be segregated from the monetary policy altogether. Meeting the expenditure by deficit will increase the prices. Taxation certainly affects the general level of prices. Conversion operations definitely affect the power of the banks to create credit and the amount of bank credit.

The difference between monetary and banking policy lies in the fact that banking policy is a part of monetary policy. Change in banking policy sometimes does not change monetary policy. For instance, the decision of selective credit control would change the banking policy, but there might be no overall change in the monetary policy, as the bank credit through selective credit control policy of the central bank of a country may not affect the total volume of credit appreciably, but it may affect credit distribution among different categories of borrowers. Similarly, the policy with regard to new public issues of securities may produce monetary effects if it aims at influencing the total volume of capital investment. This will not fall in
the category of monetary policy; on the other hand, if it merely aims at discouraging types of issues and seeks to prevent unwanted expansion in some industries and encourage expansion in other industries, it will amount to monetary measure.

Objectives of Monetary Policy

Monetary policy of a country is an important aspect of its overall economic policy. It helps a healthy growth of the economy of the country, by adjusting money supply to the needs of growth, by directing the flow of funds in the required channels and by providing institutional facilities for credit in some specific fields of the economy.

The traditional agent of monetary policy is the Central Bank, which works through the monetary system with the help of commercial banks and other credit institutions. Monetary policy is so closely related to fiscal policy that sometimes these are lumped together as national financial policy. In the broader sense, monetary policy, fiscal policy and debt management cannot be thought of operating separately, but in conjunction with each other. "Monetary policy, fiscal policy and debt management cannot be divided into watertight compartments. To fence out the Treasury would be to fence in the central bank and to stifle the effectiveness of both." However,

38. Ibid., p.72.
in the narrow sense, monetary policy is identified with all the credit control measures of the central bank.

Monetary policy consists of the measures taken by the central bank to regulate credit. It operates through five interrelated factors: the availability of credit, the volume of money, the cost of borrowing, the prices of capital assets, and the liquidity of the economy. The primary task of the monetary policy is the mobilisation of resources to the proper channels.

The identification of the objectives of monetary policy becomes our first task, if we want to analyse the appropriate monetary policy. The objectives of monetary policy differ with the economic conditions of the country, still there is a spectrum of objectives that a country can adopt. Since monetary policy is a means to an end and an end in itself, it is expected to achieve certain objectives determined by the monetary authority and/or the State. Its objectives must be regarded as being part of overall economic objectives; to the extent that monetary policy is concerned with subsidiary objectives of its own, these latter must assist in attaining the basic objectives of economic policy.40

The objectives of monetary policy have been changing from time to time. The instruments available to the central


bank also differ from country to country. Even for the same country the objectives differ at different times. Monetary policy in the narrow sense has signified one thing at one time and another at another time. Its objectives change with the changes in the conditions of the economy. Empirically also, this type of generalization can be tested. Still monetary policy has been directed to achieve a few traditional and set objectives.

Under the gold standard, maintenance of exchange stability was the most important objective of monetary policy. Because the monetary system was an automatic system, the central bank was practically passive. The supply of money was regulated by the automatic inflow and outflow of gold. "At that time scarcely anyone, considered that price level would ought to be the care and pre-occupation for less a main objective of policy", of a central bank.41

After the end of first world war, with the decline of gold standard, the central bank was expected to exercise a discretionary influence on monetary system. The international monetary instability, the growth of nationalistic feelings, the rigidities in economic structure and the appearance of a huge volume of 'hot money' sounded the knell of the gold standard. In the words of Sayers, "the Inter-war period can perhaps be called the heyday of central banking.42 There was a good deal of discussion about the

41. Radcliffe Committee Report, p.17.
objectives of monetary policy in the changed circumstances. The MacMillan Committee (1929-31) spoke of the Central Bank as being called upon to look after the maintenance of the parity of the foreign exchanges without unnecessary disturbance to domestic business, the avoidance of the credit cycle and the stability of price level. In the changed circumstances, the regulatory functions of central banking were emphasised.

With the emergence of Keynesian Revolution, maintenance of full employment became the objective of monetary policy. With the advent of great depression in 1929, resulting in mounting unemployment, the role of monetary policy to stimulate total demand and thereby help maintenance of a high level of income was emphasised. This was sought to be achieved by making available enough credit at a low cost. Thus, cheap money policy was adopted. But experience and the lessons of 'General Theory', made the people believe that monetary policy was completely ineffective. It is easy to discourage investment by raising interest rate, but we are not sure that lowering the interest rate would increase investment. Moreover, cheap money policy was indispensable to loan financed compensatory spending. The scope for effective anti-depression monetary policy is clear from the fact that "even if credit policy is incapable by itself of turning the tide of depression it can increase overall liquidity via open market operations and other conventional

43. Radcliffe Committee Report, p.17.
methods, thereby creating the monetary atmosphere necessary for the successful operation of more effective measures of fiscal and other policies".44

After the second world war, the inflationary trends in the world again revived the interest in monetary policy, specially in the interest-rate mechanism. Dear money policy as a measure of controlling inflation caught the attention of the policy framers. The political feasibility of effective fiscal policy in the form of tax increases and reduction in expenditure was doubtful. Central bank's credit control measures seems to be more effective in controlling credit expansion. An additional reason was the relative freedom of the central bank to operate unpopular anti-inflationary monetary measures. The following extract from Radcliffe Committee Report amply bears this out:

"The most serious handicap of fiscal measures, as a method of operating on the level of demand, is that individual tax changes, as distinct from the budget total, have to overcome opposition on varied grounds having nothing to do with the general economic situation. Their timing, too, is handicapped by dependence on the parliamentary time-table; and there are real administrative difficulties in making frequent changes in many tax rates. The more flexible the fiscal weapons can be made, the less will it be necessary to rely on monetary measures. On the

other hand, if the authorities are unable to manipulate taxation with sufficient flexibility, there will have to be more reliance on monetary measures.\textsuperscript{45}

The latest analysis of the objectives of monetary policy attains a different shape as compared to the conditions explained above. Radcliffe Committee, which examined the working of the monetary policy, makes a list of a new set of objectives to be followed by the monetary authorities. They include the attainment of full employment, stability in the internal value of money, steady economic growth, some contribution to the economic development of other countries and strengthening of international reserves.

In this constellation of objectives, there are possibilities of conflict among these five objectives. Stability of price and stability of internal value of money remain the major objectives. The government, independent of the economic situation in the country can not decide at its own, which objective is the foremost. It depends upon the importance of each of these objectives.

To choose any one of these objectives is not a problem, but it is very difficult to bring out coordination and consistancy among different objectives. In addition to traditional objectives, economic growth has become an important objective of monetary policy. In a developing country, economic development with an equitable distribution

\textsuperscript{45} Radcliffe Committee Report, p.185.
of income becomes a central objective of monetary policy. In the administration of development objective a number of difficulties may arise. Economic development is a moving target; it is indefinite. It is possible to predict the projected rate of growth but to find out the ideal rate of growth is a problem. 46

Monetary Policy in underdeveloped countries

Before the formulation of monetary policy for the developing countries, there should be a proper understanding of the nature of developing economies. A developing economy can be described as having low-income—low-saving—low-investment vicious circle. Savings are low because of the inherent difficulties in the generation of high rate of savings. Investment is not only low but its composition or pattern is also faulty. It should also be observed that owing to the lack of technological advancement, the "fruition-lag" or the "gestation period" is relatively longer. Like the composition of investment, the pattern of saving also calls for very careful attention. Economic development requires structural adjustment and corrections of inherent imbalances among the various sectors.

For a developing country like India, a network of policy measures is required, so that every loop is plugged, which can jeopardise the process of growth. The following statement can best show the necessity of such an action.

"A battery of policy measures will be called for to channel the flow of resources into the investment goods sector and away from the consumption goods sector; to provide appropriate price inducements for the purpose of attracting resources into new investment; and at the same time, to contain the inflationary resources generated by the creation of money incomes whose impact upon the prices of food grains and wage goods generally is likely to be very strong; and last but not the least to cope with the balance-of-payments problem by export promotion and import substitution." 47

The first approach to monetary policy can be to assist the process of economic development, which is the core need in a developing economy. Monetary policy has twin roles to play in a developing economy as regards economic development. It can help monetization of the economy by creating money supply and institutionalization of saving and investment. The generation of money in the economy increases the money income of the economy. By and large, the increase in money supply should be in line with the increase in the real national output. But the experience of the developing countries has been that the increase in money supply is faster than the increase in the real national output. It leads to increase in the price levels. Moderate price rise

is congenial to the economy as it leads to more savings, but this price rise is generally apt to escalate into stark inflation.

As regards the second role, an increase in the supply of financial assets together with their diversification in respect of yield and maturity is likely to cater for the needs of the savers in the various income strata. This will lead to "a larger amount of savings and will tend to finance the growing needs of investment in a rapidly changing economy". 48 This process has to be stimulated through the growth of financial intermediaries which will assist in the process of efficient allocation of investible funds. 49 It has been an important aspect of monetary policy in the developing countries to promote and organize development financial institutions and other types of intermediaries in various sectors.

The postwar experience shows the imperative necessity of association of a high rate of economic development with price stability. The main emphasis of monetary policy, therefore, should be to assure an amount of money supply which will be adequate enough to support the envisaged rate of economic development. At the same time, the rate of money supply should not fall below the rate of growth of real output, otherwise deflationary trends will develop. The

48. C.D. Deshmukh, op.cit.
49. J.G.Gurley & E.S. Shaw, op.cit.
concept of a 'safe' rate of increase in money supply has come into use in recent years to help in determining whether monetary expansion in a particular case has been adequate, inadequate or excessive. A 'safe' rate of money expansion can be quantitively determined by dividing the aggregate national income at current prices by total money supply at that time. Judged by this criterion, there has been an increase in total central bank credit beyond the safe limit in several developing countries. Besides India, this safe limit crossed in many developing countries in Africa during 1960-65, such as Ghana, Libya and Sudan; and in Mexico, Nicaragua, Paraguay and Indonesia in the earlier period.  

In the developing countries the role of monetary policy becomes promotional. This nature of monetary policy makes the role of the central bank of such countries entirely different. The traditional objective of monetary policy, and the central bank of the country has been to control the commercial banks, but in such countries, the primary objective is the encouragement of long-term development in the key sectors of the economy. The contribution to the regulation, direction and guidance to the credit institutions, as may exist at the time must be a secondary and less considered objective of the monetary policy; whereas its assistance to the process of economic growth and capital formation is assessed as the first and foremost objective.  

Rapid economic development of these countries is blocked due to the institutional gap between the money and capital markets. The banking system, as it is, is also not properly organised. The branches of the banks are generally spread over the urban areas only, leaving the rural areas, a large part of it, without banking facilities. People have not developed banking habit, which is evident from the fact that only about one third of the total money supply is held in the form of demand deposits, which in turn reduces the capacity of the banks to finance economic activities.

The banks also channelise their funds towards financing foreign trade and commerce and meeting the short-term requirements of large enterprises. The medium and long-term credit needs of industry and agriculture remain unfulfilled. This may be done by other financial institutions like, saving banks, agricultural credit agencies, and insurance companies. Since such institutions are not adequate quantitatively as well as qualitatively, the growth of such institutions becomes a pre-condition to step up capital formation. As such the central bank has a vital role to play in developing the financial infrastructure.

Developing countries are not properly monetized. With a large unorganized sector, the bank rate changes do not have the desired effects. The central bank in a developed country, on the other hand, can quickly buy large amount of government securities as a means of increasing bank reserves and liquidity. The open market operations in developing countries are not used smoothly.
Another consideration in this connection is the need for a central bank to ensure that the commercial banks' operations in the country are being conducted on a reasonably sound and prudent basis. In the developing countries, with a banking structure at an early stage of development, the authorities would usually find it advisable to adopt special commercial banking legislation which is administered by the central bank. Besides creating healthy commercial banking, it will protect the interests of the depositors in order to stimulate banking habits of the community. Therefore, it is imperative that the growth of these peripheral credit agencies should take place on a sound footing. The activities of financial institutions like building societies, insurance companies, investment trusts, credit cooperatives, savings banks and the like have repercussions on the banking system.

Again, as the Radcliffe Committee has reported, credit controls cannot be confined to commercial banks; to be effective they must extend to those institutions which are partial substitutes for banks and which may indeed be brought into existence by the application of controls on bank credit. Hence, in order that the central bank may successfully serve as a development agency, it should be empowered to exercise its powers over other financial institutions also.

52. Ibid., p. 31.
53. Radcliffe Committee Report, para 511, p. 182.
The best policy, which the developing countries may adopt has rightly been suggested by Friedman. Some of the prescriptions are purely theoretical, whereas a few can be applied without any danger of their non-applicability. A very extreme suggestion is the abolition of the Central Bank. But doing away with the Central banking and linking the currency with the currency of a large, relatively stable and developed country has very less feasibility.

The second-best prescription is to require central bank to produce a steady and moderate rate of monetary growth, using the new money issued to finance part of government expenditures.

One caution, which is linked with the second prescription is that inflation should never be repressed. This is the most important single lesson of experience. Whatever may be the rate of monetary growth, the resulting inflation should be permitted to be open.

Repression of inflation means a situation in which at least an important class of prices, though not necessarily all prices, are prevented from rising. Prices here include wages, interest rates and exchange rates.

Perhaps the greatest damage is done by trying to repress exchange rates. One very prominent reason of a depressing record of India's development has been the attempt to repress inflation and particularly to peg the exchange rate. We finally devalued the rupee. Instead of letting


55. Ibid., p.277.
the rupee exchange rate float, India has tried to peg it at a new level. The result has been to force India to ration imports and to subsidise exports and import—competing goods.

Another dramatic example of the effects of open and repressed inflation is provided by the experience of Germany after the two world wars. After World War I, Germany faced hyper inflation. Prices rose tremendously, but in the absence of price controls, it was possible to use the price system to organise the economy.

After World War II, inflation cropped up again. This time, prices were put under control. The inflation was not allowed to turn into hyper inflation, but with serious consequences output was cut to roughly half the prewar level. People were driven to engage in barter. Nobody was willing to buy or sell for official money at prices that were about one-quarter the market-clearing prices.

In 1948, the elimination of price controls produced a doubling of German output within a fairly brief period, solely because the price system was permitted to operate freely.

These examples show that all types of artificial controls are harmful. In many developing countries in recent decades, the easiest route to development and capital formation has been special access to import permits and foreign exchange at a pegged rate.
A good monetary policy cannot produce development, but at the same time, given a favourable precondition, it can facilitate development.

**Landmarks in Monetary Policy in the context of some major countries**

Monetary Policy has been widely discussed throughout the present century. It was brought in the limelight especially when the world was noting the gold standard crises. Monetary policy as an effective measure of economic stability was very much doubted those days. Reduction in the rate of interest and all other measures became almost ineffective. After the abandonment of gold standard, a large part of the world remained exercising monetary policy in the direction of maintaining cheap money supply as a reflationary measure. This was an inevitable outcome of the great depression of the 1930s. A number of countries liberalized the reserve requirements. To achieve the ends of reflation, official discount rate and open market operations were employed. These measures, brought in their wake, inflation during the second world war. It became an important problem for the governments. But after the war, to control inflation, fiscal measures were adopted in place of orthodox monetary controls. Higher rate of taxation, consumer credit rationing and some sort of price and rent controls were resorted to. The purpose behind these measures was to maintain cheap money, with primary reliance on non-monetary controls.
Notwithstanding the nature and tendencies of inflationary conditions, the necessity for some strong anti-inflationary measures was felt. But the governments were unwilling to discard cheap-money policy. Even the discount rate was not re-employed as an antidote. Even before 1946, the discount rate was used as a method of credit only in a few countries. It was prevalent in Belgium, France, Italy, West Germany, Finland, Greece and Ecuador. In Belgium the rate was raised from 1% to 2\% per cent in November 1946, to 3 per cent in December, 1946, and to 3\% per cent in August 1947. In Italy in September 1947 it was raised from 4 to 5\% per cent. In France it was raised from 1\% to 2\% per cent in October, 1947, and in West Germany, in 1948, it was increased from 3\% to 5 per cent. The discount rate was as high as 10 and 12 per cent in Ecuador and Greece respectively in the year 1948.56

Beside the discount rate, the reserve requirements were introduced in Belgium, Italy and France. The primary object of reserve requirements was to restrict the capacity of the commercial banks to create credit. In Italy and France, the central banks also exercised their power to have a direct control over the bank advances. These measures in these countries, helped to increase the effectiveness of discount rate policy. But unfortunately the results of such a policy were offset by the necessity of the governments to have more credit facilities from the central and commercial banks.

Other democratic countries were also facing the problems of inflation, but these countries did not like to use same orthodox methods such as the discount rate policy to combat inflation. Countries like the United States allowed the interest rate to rise in the short-run, but in the long-run interest rate was pegged at a relatively low rate. On the other hand in Great Britain, Canada and South Africa, the short-run interest rates were made to rise. These countries adopted only monetary control, prior to 1951, when bank credit was restricted by direct intervention. This restriction was imposed on the banks either under statutory powers or by means of moral suasion. The Federal Reserve Bank of the U.S., the Bank of Canada and the South African Reserve Bank, had no statutory powers to issue directives to the commercial banks concerning their lending operations, but their cooperation was sought for on many occasions.

One major landmark in the monetary policy of the world was the chain of devaluations in 1949. Devaluation in the countries concerned and subsequently, the Korean War, made most of the countries realise the importance of restriction of credit by regulations and moral suasion. Soon after the out-break of Korean War a series of increases in the official discount rates were started in most of the countries. In the year 1950, the official discount rates were increased to 5 per cent in Denmark, 1\(\frac{3}{4}\) per cent in United States, 4 per cent in Holland,
2 per cent in Canada and 6 per cent in West Germany. Discount rates were also raised in Japan, Austria, Ceylon, Chile, Bolivia and in New Zealand. The following table depicts how the changes in the discount rates occurred.

**Table 1.1**

Movement in Discount Rates in some countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Month/Year</th>
<th>Rate of Discount</th>
<th>Rate already Prevailing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Nov., 1946</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dec., 1946</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Aug., 1947</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sep., 1950</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>Italy</td>
<td>Sept., 1947</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>France</td>
<td>Oct., 1947</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sep., 1948</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Oct., 1948</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Nov., 1951</td>
<td>4%</td>
<td>1%</td>
</tr>
<tr>
<td>West Germany</td>
<td>April 1948</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Oct. 1950</td>
<td>6%</td>
<td>4%</td>
</tr>
<tr>
<td>South Africa</td>
<td>Oct. 1949</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>March 1952</td>
<td>4%</td>
<td>3%</td>
</tr>
<tr>
<td>Denmark</td>
<td>July 1950</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Nov. 1950</td>
<td>5%</td>
<td>3%</td>
</tr>
<tr>
<td>United States</td>
<td>Aug. 1950</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Jan. 1953</td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>Holland</td>
<td>Sep. 1950</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>April 1951</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>Canada</td>
<td>Oct. 1950</td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>Great Britain</td>
<td>Nov. 1951</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>March 1952</td>
<td>4%</td>
<td>2%</td>
</tr>
<tr>
<td>India</td>
<td>Nov. 1951</td>
<td>3%</td>
<td>3%</td>
</tr>
</tbody>
</table>

Source: M.H. Docock, Central Banking.
Increase in the discount rate in these countries led to other monetary control measures. Secondary reserve requirements of various types were imposed in Sweden, Holland, Mexico and India. The control of quantitative and qualitative credit was started in countries like the United States, Australia, New Zealand and South Africa.

By the end of 1950, some of the countries found themselves in a position to lower the discount rates, because due to restriction in credit, some of the consumer goods industries had to face a slackening internal demand. Because of the satisfactory reactions to the monetary and fiscal measures which had been applied in 1950, the discount rates were further reduced in the year 1951 and 1952. Only a few countries like South Africa, Japan, Greece and Ecuador decided to maintain their higher rates, while most of the countries reduced it. On the other hand the National Bank of Denmark raised its rate from 4½ to 5½ per cent in June 1954.

The foregoing analysis illustrates the trends towards a reorientation of monetary policy. The monetary operations of the United States and the U.K. need a close look, because both these countries have predominant international economic importance. In the U.K., the most important development in monetary policy has been Radcliffe Committee recommendations.
The Radcliffe Committee Report

Under the chairmanship of Lord Radcliffe, a committee was constituted by the British Government "to enquire into monetary problems and how the monetary machine in Britain works." 57

The Radcliffe Committee started working exactly thirty years after a similar Committee, called MacMillan Committee. After thirty years, the British Government had to ask this committee to examine the working and operations of monetary policy in Britain because during this fifties, nearly everybody in Britain was puzzled about the working of monetary policy. After a lapse of twenty years, in the years 1955, 1956 and 1957, the British government reactivated monetary policy. During these years, they had used it rather very sharply. Interest rates has been caused to rise considerably. The money supply had been limited. The banks had been told to lend less. Inspite of all these measures, the inflationary forces could not be controlled. The Radcliffe Committee was appointed to solve this puzzle.

The Committee was entrusted with only one work, to see into the working of monetary system in Britain. It was not told to produce a solution for the problems of inflation. When the Report was published, it was criticized

on the ground it did not give the answer to the problem of inflation. But the Committee was not at fault, because it was asked to look into monetary policy and its operation only.

Furthermore, the Committee was not asked to study in detail the fiscal or budgetary policy or the question of direct controls. Nor were they asked to consider whether the movement of wages and costs and prices may lead a little life of its own, apart from what may be done by Government to regulate the general level of demand. 58

The report gives a great deal of very valuable factual data. It also reflects significant changes in the theoretical analysis of domestic monetary policy. The report hinted at some theoretical misunderstandings which were common among the monetary experts. The report expounds a doctrine which can be divided into four parts.

(1) "... the supply of treasury bills and not the supply of cash has come to be the effective regulatory base of the domestic banking system." (para 583)

(2) "... Only very limited reliance can be placed on the 'interest incentives', as an influence on total demand". (para 397)

(3) "... it is the liquidity position as a whole upon which the authorities must act." (para 312)

58. Ibid., p. 3.
(4) "... monetary action works upon total demand by altering the liquidity position of financial institutions and of firms and people desiring to spend on real resources; the supply of money itself is not the critical factor."

(- para 361)

Out of these four propositions, the second one is not surprising because enough has been said on this point. The empirical researches and theoretical developments have proved that interest rate is not the sole factor determining the inducement to invest. But the rest of the propositions do not reconcile with the general analysis.

The first proposition was perhaps the result of the arrangements which were made to ensure that the Government can always lay its hands on the funds necessary to discharge its day-to-day obligations. It was thought that the arrangement of necessary funds was the function of the Bank of England, being the banker to the Government. But it has been proved that such actions by the Bank of England caused inflation because treasury borrowings from the Bank of England expanded the cash base thus allowing a multiple expansion of bank credit. It is a function of the discount market to supply the Treasury with funds. The discount houses acting together as a syndicate, are under an obligation to take up all bills which cannot be sold to outside lenders at a better price. In case the discount houses do not get sufficient funds for the purpose, the Bank of England
must come to their rescue to avoid any disturbances in the market. From disturbances, the committee meant the situation when there is excess demand for funds which may push up the prices. The motive of the Bank of England is to stabilize the short term rate of interest. The committee asserted that the cash which the Bank of England makes available to the discount market for loan to the treasury is less inflationary than if it is lent directly. But the Committee did not approve of the assumptions on which the need for this action is based. The committee expressed "doubts whether a reversal of all this would now have any catastrophic results for the Treasury".59

Due to this stable rate (short-term market), the first proposition holds good, wherein the committee suggests that the supply of treasury bills and not the supply of cash has come to be the effective regulatory base of the domestic banking system. The banks are obliged to hold 30 per cent of their assets in liquid form; this means cash or bills or short term loans to the discount market. Since the banks can get cash by calling money from the market, thus forcing the Bank of England to create more cash, the cash ratio is of no significance; it is the liquid assets ratio which restricts bank lending. Hence, bank credit is based on total liquid assets and not on cash.

But sometimes more than two third of these liquid assets themselves are bank credit, and bank credit itself,

59. Radcliffe Committee Report, para 385 and 387.
as a whole, is based on cash. Here lies the controversy between cash-based liquidity and the credit-based liquidity. A reasonable interpretation to it can be that bank credit is still based on cash, but the authorities have chosen to allow the cash base to be determined by requirements other than the requirements of monetary restriction. There remains still the ability of the authorities to control bank credit (at least a part of it, by altering the supply of treasury bills).

In other words, if the banks are deprived of treasury bills of an amount equal to $X$, their obligation regarding liquid assets forces them to contract credit by $\frac{10}{3}X$, (30% being the reserve ratio). The contraction in credit does not mean the cutting of the expenditure by the government by that amount. The treasury dispenses with the bills by funding. It issues long-term securities instead. This is not only funding, but a switch from borrowing from the banks to borrowing from the public. The net effect will be to reduce deposits and the bank’s treasury bill holdings by $X$, as a result of which they will have to contract credit by $\frac{10}{3}X$.

But the operation so far has not affected the bank’s cash, since the borrowing on bonds is exactly offset by the repayment of bills, but the sale of bonds will reduce deposits by $X$, thus leaving the banks with $\frac{X}{12}$ surplus cash. Will the banks not try to get a larger share of the outstanding treasury bills rather than contracting? Or lend
to the discount houses on short bonds? Or even lend to their customers by way of bills? And will this not cause a re-expansion of X, leaving the volume of bank credit as it was before the funding? Indeed it would appear that the only result would be a fall in the short term rate of interest. The solution for that can be that the authorities would need to take the X/12 surplus cash out of the market at the same time as contracting treasury bills. Unless treasury bills are contracted in proportion, that would cause a rise in the short-term rate. In other words, the contraction of the cash base is not a sufficient condition for monetary contraction simply because the authorities choose to adopt a certain interest rate policy rather than because of any change in the nature of monetary system.

As regards proposition No.3, with regard to 'the liquidity position as a whole', the Committee places great emphasis. The Committee do not actually defines liquidity anywhere, but it appears to mean the ease or difficulty encountered by spenders in their efforts to raise money for the purpose of spending on goods and services. 60 The second part of the proposition i.e. "how the authorities act" is explained in the way that the authorities influence the situation by operations on the structure of interest rates which for institutional reasons, change the liquidity of financial operators. 61 But the difficulty stems from the

60. Ibid., para 389.
61. Ibid., para 394.
faulty interpretation of the term liquidity. The Committee uses the term in different ways in different contexts. To control the liquidity, the Committee suggested changes in the value of financial assets but at the same time, in the second proposition the Committee allowed very little strength to the interest incentive effect on spending. A possible interpretation for this can be that the change in the value of financial assets is only one aspect of a change in the cost of obtaining funds. But this much is undisputable that a rise in interest rates means that financial institutions can only expand their lending by selling securities at a loss. The financial institutions cannot pass on the increased cost by raising their lending rates because there are certain conventions and agreements regarding rates. The bank's lending rate to the discount houses and the bank's advances rate are related to bank-rate; they do not reflect what the market will bear. It will certainly restrict the profits of financial institutions but the study of the profits of financial institutions was not the subject of Committee's consideration.

The Committee did not clearly specify that assets would qualify as liquid assets in case of banks, but it seems to imply that it had in mind those assets which are at present included in liquid assets. It is possible for the banks, within limits, to satisfy a higher liquidity ratio by the simple device of lending by way of bills instead
of advances. Controls of this type depend upon the institution concerned keeping to the present conventions in the circumstances in which it would not be in their interest to do so because it would divert business into other financial channels. But such a control would need to be accompanied by restrictions on other financial institutions because they all contribute to the general liquidity position. In simple terms the banking system determines the volume of money and other financial institutions influence its velocity. With regard to the velocity, the Committee states, "We have not made more use of this concept because we cannot find any reason for supposing, or any experience in monetary history indication, that there is any limit to the velocity of circulation."\(^{62}\)

But how can it be said emphatically that velocity of money has any absolute limit or its limit, if any, has any bearing on its validity or utility.

**Critical Appreciation**

The report of the Radcliffe Committee has a mixed reception. The disappointment springs due to two reasons:

1. Its apparent disinclination to give a clear lead on many important issues.
2. Lack of clarity on some of its arguments.

It seems that an opportunity was missed because Committees on such issues are rarely appointed. Let us

examine, one by one, the efficacy of the tools suggested by the Committee to control the persistent inflationary pressures.

It was emphasised that it is on the total pressure of demand that monetary measures should in the first place be expected to work. Theoretically, the monetary authorities could influence the total level of demand in two ways:

1. by bringing about a change in interest rates, thereby inducing a change in the incentive to business firms, government bodies and consumers to purchase capital goods, and so cause a change in actual spending on labour and other factors of productions - the so called "Interest incentive effect"; and

2. by influencing the liquidity condition of financial institutions and of business firms and people generally.

So far as the interest incentive effect is concerned, there is no convincing evidence of its effect in recent years. As the Committee itself has noted, "a business decision turns on a whole complex of factors, usually without any conscious attempt to assess the relevance of any particular factor".63 To say that, the Committee should have discovered

witnesses from commerce and industry, as well as financial institutions and the academic world, who were accustomed to think of interest rates as being high, low or normal.

The next question was how best to influence the liquidity of those institutions that influence the liquidity of others. To bring about changes in the liquidity, interest rates were found to have a central part to play; the method of implementing such changes being the management of debt. The potency of debt management as a weapon of control has undoubtedly increased because of the expansion in the size of the debt. The authorities cannot remain neutral to debt management even if they want so, because its size has increased tremendously. The authorities have been presented with an opportunity to employ the debt management, by this report, in the task of influencing the pressure of total demand.

The emphasis in the Committee's argument on debt management is highly interesting, if not completely convincing. But the successful operation of debt management will depend upon the willingness of the constituents of the market for debt - recognising the wisdom and leadership of the government. Once the government loses faith or miscalculates, the whole superstructure of debt management will collapse.

Debt management has certainly a part to play. But the Committee appears to have been looking for some new
delicate and beautiful instruments to replace Bank Rate Policy as the cornerstone of monetary action.

Then the Committee was unable to predict the course of monetary developments in the 1960's. It could only say:

"... Our review of monetary measures has not led us to any positive and simple recommendations. No method, new or old, provides the remedy for all troubles. We do not find any solution of the problem of influencing total demand in more violent manipulation of interest rates; we find control of the supply of money to be no more than an important facet of debt management; we cannot recommend any substantial change in the rules under which the banks operate; we do not regard the capital issues control as useful in ordinary times; and we believe that there are narrow limits to the usefulness of hire purchase controls."

Regarding the efficacy of monetary measures, the Committee has little faith in monetary policy as such. To quote the report again:

"... When all has been said on the possibility of monetary action and of its likely efficacy, our conclusion is that monetary measures cannot alone be relied upon to keep in nice balance an economy subject to major strains from both without and within. Monetary measures can help, but that is all."
In the light of the above discussion over the definition and role played by the monetary policy, and after formulating its objectives, we can easily examine what the monetary policy can do and what it cannot.

**What Monetary Policy can do**

The first and most important lesson that history teaches about what monetary policy can do—and it is a lesson of the utmost importance—is that monetary policy can prevent money itself from being a major source of economic disturbance. It has got the potential of using money only as a catalytic agent. It can set the monetary machinery on right track without affecting anything else. It is an important and positive task for the monetary authority to suggest improvements in the mechanism that will abolish or reduce the chances that it will get out of order, and to use its own powers so as to keep the mechanism in good working order.

The second thing which monetary policy can do is to provide a stable background for the economy. It can keep the monetary machine well-oiled. The economic system will work best when producers and consumers, employers and employees can proceed with full confidence that the average level of prices will behave in a predictable way in future. The monetary authority could act as an alternative to gold standard, which had an element of automaticity and certainty in the behaviour of prices.
Finally, monetary policy can contribute to offset major disturbances in economic system arising from other sources. If there is a danger of secular exhilaration—as the postwar expansion was described by the proponents of secular stagnation—monetary policy can help to hold it in check by a slower rate of monetary growth than would otherwise be desirable. If, as now, an explosive budget threatens unprecedented deficits, monetary policy can hold any inflationary dangers in check by a slower rate of monetary growth than would otherwise be desirable. This will temporarily mean higher rates of interest to enable the government to borrow the sums needed to finance the deficit. But by preventing the speeding up of inflation, it may well mean both lower prices and lower nominal rates of interest in the long-run.

**What Monetary Policy cannot do**

The first limitation of monetary policy is that it cannot peg interest rates longer than a very limited period. This limitation derives from a much misunderstood feature of the relation between money and interest rates. To keep the rates low, the central bank will buy the securities from the public. This raises their prices and lowers their yields. In the process it also increases the reserves of the banks, hence the amount of bank credit, and ultimately the total quantity of money. This increase in the quantity of money will reduce the interest rates. But a negatively sloping
liquidity preference schedule cannot be set aside. In the academic world, this slope of the liquidity preference schedule is more important than the increase in the quantity of money. Rising of quantity of money may also increase the liquidity preference schedule and the demand for loans. It may also raise the prices, which would reduce the real quantity of money. These effects will reverse the initial downward pressure on interest rates.

Another effect of increasing the quantity of money can go still further, and it may mean that a higher rate of monetary expansion will correspond to a higher and not lower level of interest rates. Let the higher rate of monetary expansion produce rising prices, and let the public come to expect that prices will continue to rise. Borrowers will then be willing to pay and lenders will demand higher interest rates - as Irving Fisher pointed out decades ago. This price expectation effect is slow to develop and also slow to disappear. Fisher estimated that it took several decades for a full adjustment and more recent work is consistent with his estimates. It explains, historically, why rising nominal interest rates have been associated with rapid growth in the quantity of money. Brazil, Chile, and the United States are the best examples. Conversely, falling interest rates have been associated with slow growth in the quantity of money, as in Switzerland now or in the United States from 1929 to 1933.
The second limitation of monetary policy is that it cannot peg the rate of unemployment. Again, it seems contrary to the generally known objective of monetary policy that it can lead to full employment, or at least it can stimulate employment. But in reality, it cannot. The reason is precisely the same as for interest rates the difference between the immediate and the delayed consequences of such a policy.

At any point of time, there is some level of unemployment, which has the property of being consistent with equilibrium in the structure of real wage rates. At that level of unemployment, real wage rates are tending on the average to rise at a normal secular rate, i.e., at a rate that can be indefinitely maintained so long as capital formation, technical improvements, etc., remain on their long-run trends. A lower level of unemployment is an indication that there is an excess demand for labour that will produce upward pressure on real wage rates and vice versa. The "natural rate of unemployment", in other words, is the level that would be ground out by Walrasian system of general equilibrium equations, provided there is imbedded in them the actual structural characteristics of the labour and commodity markets, including market imperfections, stochastic variability in demands and supplies, the cost of gathering information about job vacancies and labour availability the costs of mobility, and so on.

To convert the argument in simple words, let us start with the authorities increasing the quantity of money to reduce unemployment. This will be expansionary. Initially, it will lower the interest rates and stimulate spendings. Income and spending will take the form of increase in output and employment rather than in prices. People have been expecting prices to be stable, producers will tend to react to the initial expansion in aggregate demand by increasing output, employees by working longer hours, and the unemployed, by taking jobs now offered at former wage rates.

Increase in prices (selling prices) moves faster than the wage rates (or other factor prices). Real wages received will go down. Real wages anticipated were high, because the employees implicitly evaluated the wages offered at the earlier price level. This simultaneous fall (ex-post) in real wages to the employees and rise (ex-ante) in real wages expected, is what enabled employment to increase. But the decline (ex-post) in real wages will soon affect the anticipations. Employees will start demanding higher nominal wages for the future. 'Market' unemployment is below the 'natural' unemployment.

Even though, the higher rate of monetary growth continues the rise in real wages will reverse the decline in unemployment. Ultimately, it will lead to a rise in unemployment. The monetary authority will again try to reduce unemployment by increasing money, but the circle will never end. As in the interest rate case, the 'market'
rate can be kept below the 'natural' rate only by inflation.

To conclude differently, "the monetary authority (or policy) controls nominal quantities—directly, the quantity of its own liabilities. In principle, it can use this control to peg a nominal quantity—an exchange rate, the price level, the nominal level of national income, the quantity of money of one or another definition—or to peg the rate of change in a nominal quantity—the rate of inflation or deflation, the rate of growth or decline in nominal national income, the rate of growth of the quantity of money. It cannot use its control over nominal quantities to peg a real quantity—the real rate of interest, the rate of unemployment, the level of real national income, the real quantity of money, the rate of growth of real quantity of money." 65

Monetary Policy in India

Credit control is, no doubt, a very important tool of monetary policy, but what has interested central banking in India with particular significance is not mere regulation of credit but the task of building up the financial infrastructure for economic growth and to lay the foundation for an effective contribution by institutional agencies to the finance of industry and agriculture.


In the nature and developed economies of the world, the role of monetary policy is broadly regulatory. But in a developing country the promotional role of monetary policy is more important than the regulatory. The glaring characteristic of monetary policy in India has been co-ordination of the developmental and regulatory role of the Reserve Bank of India. The twin criteria of promotion and stabilization have to be applied to make a proper assessment of its monetary policy.

The institutional setting in India is not so unfavourable to the employment of vigorous monetary policy as in other developing countries. The banking and monetary framework of the country, though not comparable to that of developed countries, is not rudimentary in the sense it is in some South-East Asian and African countries. There is an unorganised monetary sector in India, but the monetization is fast expanding, the banking system is developing and becoming more extensive. The peculiarities of the country's economy may set some limits to the extent to which central banking policy can make itself felt, but they do not significantly impair the effectiveness of the range of the control weapon of the Reserve Bank of India.

The Reserve Bank of India has faced conflicting responsibilities since planning started in India. On the one hand, it has been entrusted with the task of financing development plans by expansion in money supply and credit and on the other hand it has the responsibility of envisaging the consequences of expansion in the money supply.
and credit in the form of inflationary pressures. A great deal of the development expenditure is being devoted to investment projects whose 'fruition lag' or 'gestation period' is pretty long with the consequence that the upward pressure on the prices of consumer goods is continuous. In such circumstances, the Reserve Bank has had to regulate the supply of credit so as to hold in check this pressure and temper the needs of development by a policy of monetary restraint. It has been a policy of 'controlled expansion', which has been aimed at general restraint but at the same time has facilitated the flow of credit into particular sectors. In a policy of controlled expansion it must be stressed that expansion is as important as control. In a developing economy where credit requirements are continually expanding and where investment has to be undertaken within the framework of an economic plan, the control of credit expansion has to be geared dimensionally and directionally to the overall needs of the plans. Within the framework of these twin objectives, what the Indian Monetary Authority has done and what shape the monetary policy has assumed is discussed.

The Reserve Bank of India has taken certain promotional steps, which do not come under the direct control activities of the Reserve Bank. It has, along with the government, initiated the development of a battery of specialized financial institutions like the Industrial Finance Corporation of India and the State Financial Corporations for financing the industrial development of the country. It has subsequently come to over a full-fledged Development Bank, the
Industrial Development Bank of India, and even to administer its industrial loans business through a common board of directors. It has also played a vital part in the reconstruction of the co-operative credit institutions to improve their working. The Reserve Bank has an Industrial Finance Department and an Agricultural Credit Department through which it advises the States Financial Corporations and the cooperative banks regarding policy matters and issuing of their bonds.

The Reserve Bank of India has also actively promoted the balanced growth of the banking system and improved its efficiency through the wide powers of control and direction conferred upon it by the Banking Companies Act, 1949, and its subsequent amendments. The expansion of these financial institutions has served to bring within the banks' purview a large segment of the organised capital market and has made more effective its regulatory functions. The promotional role of the Reserve Bank is to be seen not only in its efforts to fill up the gaps in the credit structure but also in the creation of a state sector in commercial banking.

This creation of a state sector within the commercial banking system which began with the nationalization of the Imperial Bank of India in 1955 has culminated in the nationalisation of fourteen major Indian banks in 1969. This development has introduced a remarkable structural change in the Indian Banking system. It has provided the Reserve Bank with an important instrument for initiating geographical
as well as functional expansion of the Indian Commercial banking system. Although we believe that the range and variety of a central bank's functions in a developed country is different from those in a developing country, we fear that "a wide ramification of the activities of the central bank in the various sectors of the economy may lead to a sheer dilution of the essence of central banking." 67