CHAPTER I

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The present study seeks to analyse the problems of monetary management in underdeveloped countries. It focuses attention on and draws on the experience of India during the period of three Five Year Plans (1951-52 to 1965-66). As A.J. Brown has so well observed "the behaviour of monetary systems provides one of the most rewarding fields of empirical study to be found in the whole of economics".[1]

The present study is largely carried out in terms of an interpretative framework i.e. there is an emphasis on interpreting the nature, modus operandi and effectiveness of measures of monetary management in general and particularly in relation to an underdeveloped country like India during the period of her monetary experience of a decade and a half.

There has been more or less agreement in the post-war years now, that two theoretical frames of reference that may be used for the purpose of interpretation of the working of a monetary system are the 'quantity theory' and the 'Portfolio balance' approaches.

The 'demand for money' hypothesis of the 'neo-quantity

1. A. J. Brown - "Economic Journal", December, 1959. P.773.

theory' seeks some dependable and testable[1] measure of secular behaviour of income velocity of money. Historical data in underdeveloped countries may perhaps fail to provide such dependable and testable measure. It may be argued that in the underdeveloped countries with economic planning, the projected rates of growth in income are available but to the extent these growth rates deviate from their projected values and the measure of secular behaviour of income velocity of money derived from past data is not entirely dependable, the money demand equation will have to be used with care.

On the other hand, an underdeveloped economy passes through a process of financial accumulation and here the portfolio behaviour of individuals and financial institutions may have to be paid due regard so that the 'portfolio balance' approach which, to borrow a phrase from Harry Johnson, is "long on elegant analysis of theoretical possibilities but short on testable or tested theoretical propositions"[2], may also be relevant.

Thus while the force of argument in Friedman's judgement that "the basic differences among economists are empirical, not theoretical" is to be recognised, the more cautious and more assertive part of it that "a more subtle examination of the record may be needed to disentangle

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1. and simple also in the sense of there being few variables involved.

2. Harry G. Johnson in "Money in Britain (1959-59)" Johnson and Croome (Eds). Oxford 1970. P. 105.

what is systematic from what is random and erratic"[1] could not be ignored - and more so for the underdeveloped countries. A 'monistic' approach based on a particular theoretical framework has not, therefore, been thought useful here firstly because the period of study is too small to provide any meaningful conclusions and secondly because the study relates to an underdeveloped economy which passes through a period of important structural changes. A more promising (and atleast more relevant at this juncture) line of approach may be to specify goals that monetary policy should seek to serve in the underdeveloped countries.

The 'standard four' of monetary policy goals - full employment, price stability, growth and external balance - may then better be recast as the single objective of economic growth which has been the primary politico-economic-social objective in the underdeveloped countries and which has been the basis for resorting to a programme of 'planned economic development'. The growth process will however, be associated with a price level path - rising, falling or stable level of prices. Studies done with regard to behaviour of the price level during the growth process - including the search for an 'optimum' rate of inflation have yielded varying conclusions. A sort of agnostic position is taken in regard to the price level path of the growth process with the result that no systematic and extensive treatment

1. M. Friedman "A theoretical framework for monetary analysis", Journal of Political economy, March-April, 1970. Pp. 234-35.

of inflation has been given in the work here.[1]

Underdeveloped economies experience 'financial accumulation' together with 'real accumulation' and the former process involves extension, expansion and sophistication of financial institutions and instruments. This financial aspect of economic development which basically involves use of a given savings-investment technology would be concerned with on the one hand, the importance and use of interest rates and for that matter an interest rate policy, and on the other hand an efficient working of the banking (financial) structure.

It is a plausible and realistic conclusion that monetary authorities should so design their policy that they bring about that rate of monetary expansion which would be conducive to maximal growth. For reasons stated earlier, it would be quite difficult to hit at the right rate of monetary expansion.

Monetary authorities in the underdeveloped countries would, therefore, do well to see how their policy measures affect the saving-investment process in a manner conducive to growth. Economic development fundamentally relates to the process of placing generated investible surpluses into the hands of those who would make the most efficient use of them. A rational purposive and flexible interest rate

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1. Inflationary pressures have developed in the Indian economy in a marked form after 1962-63.

policy would be instrumental in this process of placement and to an extent for generation of the surpluses also. Interest rate policy followed by the Reserve Bank of India has, therefore, been an aspect - and rather a major one - of this study.

Efficiency in monetary management relates to 'structural efficiency'[1] - efficiency of the banking system in administration of the payments mechanism and in allocation of savings capital in different channels of investment - in addition to efficiency in stabilization policy etc. It is argued that this aspect of policy should become a constituent of the goal function of monetary authorities in the underdeveloped countries. Consequently, some probing in regard to this aspect is made in this study but fullfledged treatment of it is not attempted firstly because such extensive treatment would lie outside the scope of this study and secondly because the whole issue is currently under investigation by the Banking Commission in India.

1. The term is due to Harry G. Johnson.

An omission needs to be explained before a chapter-wise outline is presented.

Related as the study is to underdeveloped countries an account of the characteristics of these countries together with issues pertaining to various forms of resource-mobilization or even some treatment of the Planning strategies in general and the one followed in India may make the study more broad-based. These issues have not been dealt with here however, because the characteristics of underdeveloped countries are now too familiar to be repeated (though in Chapter III the relevant aspects of these characteristics pertaining to monetary policy have been dealt with) and it is felt that omission of discussion of the planning strategy does not affect the general tenor of arguments here.

PLAN OF THE STUDY:

Chapter I Introduction	:	Introduction to the nature and scope of the study is presented in this Chapter.
Chapter II Theory of money and monetary policy.	:	This chapter provides a brief review of developments in the theory of money and monetary policy in the post-war years. The relevance of these developments for the underdeveloped countries has been brought out in a manner that would lie within the scope of this study.
Chapter III Goals of monetary policy - developed and under-developed countries.	:	Goals of monetary policy have been discussed in relation to both groups of countries. Having brought out the nature of economic policy on the basis of Tinbergen's analysis, a reference to constraints on monetary policy has been made with due regard to developed and underdeveloped countries. Goals of monetary policy in regard to both groups of countries have been specified. A critique of the avowed policy goal of 'controlled expansion' of the Reserve Bank of India has been presented at the end.
Chapter IV The Indian Monetary system - an overview.	:	This chapter has been interposed with a view to providing an overview of the Indian monetary system, the emphasis being on a factual account of the structure rather than behavioural relationships among its constituents.
Chapter V Instruments of monetary management (General) I.	:	This chapter provides an account and an assessment of the use of Bank Rate policy of the Reserve Bank of India during the years 1951-52 through 1965-66.
Chapter VI Instruments of monetary management (General) II.	:	The other two 'General' measures of monetary management namely 'Open market operations' and 'Variable reserve requirements' have been dealt with in this chapter. Separate treatment of the Bank Rate and clubbing together of these

<u>Chapter VI</u> : (contd)	two other instruments is based on the consideration that the Bank Rate has remained and continues to remain the prime instrument of monetary control with the Reserve Bank of India and in a remote sense, out of the sheer consideration of size appropriateness of a chapter. The treatment is to give an account and an assessment of the use of these two instruments by the Reserve Bank of India over the years 1951-52 through 1965-66.
<u>Chapter VII</u> : Instruments by monetary management. (Selective)	Prefaced with the general nature and forms of selective credit controls together with a rationale for use of such controls in the underdeveloped countries, this chapter gives a critical account of the tenor of operations of these controls in India during the years 1956-66. 'A few observations' at the end of the chapter bring out the characteristics of selective controls in India and also provide a critique of the policy followed by the Reserve Bank of India.
<u>Chapter VIII</u> : Interest rate policy in India.	In this chapter a case is made for use of a rational, purposive and flexible interest rate policy in underdeveloped countries. On the basis of the 'gap' concept of Hicks and advocacy by Gurley and Shaw for an optimum combination of four methods of the 'Savings-investment technology', a case for interest rate policy has been made out. The policy has been examined first in terms of 'allocation of resources', 'interest sensitivity of investment' and 'interest elasticity of savings', and later in terms of the structure of interest rates. Pecularities of the interest rate structure in India as they were witnessed during the years 1951-52 through 1965-66 have been brought out. The implications of variations in some selected rates of interest over the period have been dealt with at the end of the chapter.
<u>Chapter IX</u> : The question of structural efficiency.	An interest rate policy operates better in the context of an efficient banking (financial) system which again is a prerequisite for enhancing effectiveness of monetary policy. A plea is made for

Chapter IX (contd)	:	tackling the issue of integration of the banking (financial) system. As the title indicates, this Chapter aims to bring to the fore the 'question' of structural efficiency and hence no detailed analysis and interpretation of Indian data have been undertaken.
Chapter X Summary of findings and conclusions.	:	This Chapter presents a summary of findings and conclusions as arrived at in the foregoing Chapters.

Sources of data:

1. The main sources of data are the following publications of the Reserve Bank of India :

   - Currency and Finance Reports
   - Trend and progress of banking in India
   - Statistical tables relating to banks in India
   - Monthly bulletins of the Reserve Bank of India
   - Supplement to Banking and Monetary Statistics of India - Parts One and Two.

2. The financial year (e.g. 1950-51) relates to beginning of April (1950) to end of March (1951).

3. The term 'Crore' is equivalent to 10 million.