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MONEY SUPPLY AND PRICES IN INDIA
SINCE INDEPENDENCE
(1947-1960)



MONEY SUPPLY AND PRICES
IN INDIA
SINCE INDEPENDENCE
(1947—1960)

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PREFACE

Politically and economically India has literally been in a ferment since 1947. In the present book which is the product of a D. Phil thesis submitted at Calcutta University, the author confines himself to the study of one of the outstanding and interesting economic phenomena in the Indian economy in recent years namely, price movements. While giving a detailed survey of price movements, an attempt has been made to present a critical analysis of the same in the light of the intimate relationship that exists between prices and economic growth.

Economic development is not a smooth sailing; if it paves the way to plenty and prosperity, it also creates many complex problems such as those of inflation, capital formation, balance-of-payments difficulties etc. In a sense, these problems may be said to be the birth-pangs of development. Inflation, for example, there must be to some extent if a huge development expenditure has to be made to achieve rapid economic growth; higher tax rates have to be borne by people in the interest of rapid capital formation; again, the minimum development imports may give rise to a balance-of-payments deficit. All these problems, however, are at bottom related to the question of proper adjustments. For example, there must be an adequate realisation that inflation, though unavoidable and even beneficial to some extent, may be disastrous to growth itself, if left unplanned and uncontrolled. If the appropriate balance between the growth of real output and that of money supply is lost, an economy cannot be maintained on an even keel. Similarly, higher tax rates, however essential for mobilising savings for development, may raise the ticklish questions of welfare and incentives, if the rates are raised beyond certain limits. In the context of these issues, the monetary and fiscal policies followed since 1947 have been examined and some suggestions have been offered particularly with reference to the development effort that commenced with the First Five-year Plan. Though inferences have been drawn from the experiences of many developed and underdeveloped countries, the present work is essentially a case study within a limited sphere of the performance of the Indian economy for over a decade covering the two plan-periods.

The author offers his sincere thanks to all those who helped him in one way or another in completing the work. He is grateful to the staff of the Central Library, Calcutta University for the courtesy and help he received while collecting materials for the book. However, the author's deepest sense of gratitude is to his revered teacher Prof. S. N. Sen, Head of the Department of Economics, Calcutta University, under whose guidance the work was completed. In the midst of his onerous responsibilities and busy schedule, he spared much of his valuable time for reading the manuscript. The book has gained much from the suggestions he offered though any defects are of course entirely the author's.

Thanks are also due to the Publishers, Mr. S. Chakraborti in particular, for their whole hearted co-operation in bringing out the book and to Mr. D. B. Subba for preparing the index.

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INTRODUCTION

In the following pages a study has been made of some of the currency problems in India since 1947. This period in India saw a succession of events, both political and economic, which had far-reaching effects on the economy. The greatest political event was undoubtedly the partition of the country, bringing in its wake several economic problems for the Indian Union which were completely new in her experience. The greatest injury done by partition to the economy of the Indian Union was that it shattered the economic unity of India that was built through a century.

Consequent on the partition, the Indian Union had to support nearly 82 percent of the population of undivided India with only 69 percent and 65 percent of the total pre-partition yield of rice and wheat crops respectively.

Then, another serious predicament for the Indian Union was that the two important raw materials, jute and cotton, fell mostly within the Pakistan territory whereas all the jute mills and 91 percent of the cotton mills were situated within the territory of the Indian Union. Thus partition created a serious shortage of foodgrains and raw materials that were vital to the Union's economy and worsened the price situation. Apart from this, in the pre-partition days jute and cotton were important foreign exchange earners but after the partition, the Indian Union turned overnight into the heaviest importer of these two raw materials. This naturally had a serious repercussion on her balance of payments position. The partition also forced the Union Government into successive budget deficits to meet the huge expenditure for the rehabilitation of refugees and for defending the Union's frontiers properly.

The greatest paradox in the economic situation was that contrary to the general expectation of a depression and down-trend in prices after the war there was actually an inflationary rise in prices.

The general apprehension was that the cessation of the huge war expenditure, the demobilisation of the army personnel, the

closing down of war factories and the cancellation of war contracts—all these would cause wide-spread unemployment, loss of income for the masses, a fall in the demand for consumers' goods and the consequent fall in prices. But instead of anything like a general slump owing to the cessation of the combined war expenditure of the order of Rs. 600 crores the actual course of prices was highly inflationary, the general index in 1946-47 being higher by 12% over that in 1945-46. This up-trend in prices was persistent right up to 1951, the general index reaching the peak in mid-April 1951. This clearly proves that despite the apparent predictions of a depression there were several off-setting factors in the economy that constituted an inflation potential.

The next important currency event was the devaluation of the rupee, the most important single event in the field of exchange management. Alteration of the exchange rate had also been done in the past but it was in the post-war period that a major downward adjustment of the exchange rate was made for the first time in the history of Indian currency. Since a good deal of controversy raged over the advisability of devaluation, this question needs to be studied in detail.

Last but not the least important is the economic planning of the country undertaken since 1951. Planning put the economy into a new gear, the different economic variables assuming new values. Thus, with the progress of the Five-Year Plans, the national income of the economy increased and with the increase in national income, higher levels of investment and saving were reached and a new adjustment had to be made between the growth of money supply and national income. The money supply which might be called redundant in the pre-Plan period came to be regarded as the modest requirement of a growing economy. Thus, planning called for a new approach to determine the currency needs of the country.

All these make the period under review interesting for a study of currency problems. Some of the basic factors in the economy having an important bearing on the currency situation are as follows :—

While in most of the economically developed countries currency and notes form only a small part of the total money supply, in India currency is more important than deposit money

in the composition of the total money supply as illustrated in the following table¹ :—

TABLE I
(Figures in crores of rupees)

Year	Currency with the Public (1)	Deposit money with the Public (2)	Total money supply (3)	1 as. % of 3 (4)	2 as. % of 3 (5)
1947-48 ..	1,414.77	821.96	2,236.73	63.25	36.75
INDIAN UNION					
1949-50 ..	1,215.54	649.72	1,865.26	65.14	34.85
1950-51 ..	1,299.14	646.97	1,966.11	66.10	33.92
1951-52 ..	1,182.24	604.77	1,787.01	66.14	33.85
1952-53 ..	1,169.23	586.15	1,755.38	66.60	33.38
1953-54 ..	1,129.43	564.54	1,793.97	62.90	31.46
1954-55 ..	1,311.77	608.86	1,920.63	68.30	31.70
1955-56 ..	1,505.09	679.22	2,184.31	68.90	31.09
1956-57 ..	1,556.49	756.39	2,312.88	67.21	32.70
1957-58 ..	1,607.13	782.22	2,389.35	67.27	32.73
1958-59 ..	1,725.36	774.23	2,499.59	69.02	30.97
1959-60 ..	1,862.72	840.41	2,703.13	68.90	31.08

From the table it is clear that the ratio of currency to deposit money in India is approximately 2 to 1. The preponderance of currency in the composition of total money supply may be partly explained by the lack of banking facilities, non-banking habits of the people, their apathy to the use of modern banking techniques and their definite preference for cash as against bank-deposits. This preference of the people for coins and notes has set up a monetary pattern that militates against an effective and prompt credit control by the Reserve Bank through the classical control measures. As admitted recently by the Governor of the Reserve Bank of India, "the framework in India is not comparable, either in coverage or in the degree of integration, to that in the West. Currency is more dominant than bank credit; in 1951-52, when the First Five Year Plan was inaugurated, currency formed 67 per cent of the total money supply, and to-day after six years it still forms the same percentage. This sets limitations on the extent to which monetary policy of the central banking authority can make itself felt"².

¹ Reports on Currency & Finance, 1952-53, 1960-61.

² Statement made by H.V.R. Iengar, ex-Governor of the R. B. of India at the Joint Informal Discussion at the 12th Annual General Meeting of the I.M.F. and I.B.R.D. held in Washington on Sept. 25, 1957; this has been published in his book, *Monetary Policy and Economic Growth*, 1962.

Another factor that appears to restrict the efficacy of monetary action in a semi-developed economy like ours is the existence of a fairly large non-monetised sector. According to very rough estimates, about 35 per cent of the total national income is still outside the purview of monetary transactions³. Even within the monetised sector, the estimates about the size of the organised market are still tentative. About three decades ago, the Central Banking Enquiry Committee made the estimate that about 90 per cent of the total internal trade was financed by the unorganised sector of the money market. There has, however, been a steady growth of commercial and co-operative banking since the Committee published its report and it would appear likely that to-day the organised sector of the money market has increased its share in the financing of industry and trade to about 50 per cent.⁴ Moreover, there exists a sub-area of contact between the unorganised and organised sectors. This shows that the scope for monetary measures is gradually expanding but the existence of a large non-monetized sector is still there to nullify monetary action over a wide area.

There has been no doubt a remarkable growth in deposit money in recent years. Thus, between 1956-57 and 1959-60, the increase in deposit-money by 23.5% has been almost the same as that of currency by 23.7%⁵. This growth of deposits may be a reflection of the expansion of banking facilities in the country and their growing popularity with the public. But as a medium of payment currency-notes still hold ground for the majority of the people, though for a limited sector bank-deposits may be increasingly used for transactions purposes.

Another important development in the field of currency in recent years has been the remarkable growth in time deposits as against demand deposits. The exigencies of the war being over, there was possibly a decline in the public's demand for liquidity. The result was that while the amount of demand deposits increased from Rs. 584.8 crores in 1945 to Rs. 654.5 crores in 1946 and to Rs. 671.8 crores in 1947, the amount of time deposits shot up from Rs. 194.1 crores in 1945 to Rs. 259.5 crores in 1946 and

³ *Monetary Policy and Economic Growth*, H.V.R. Iengar, 1962, p. 136.

⁴ *Ibid.*

⁵ *Report on Currency & Finance, 1959-60*, p. 28.

to Rs. 343.5 crores in 1947. During the six years 1950-51 to 1955-56, while demand deposits increased by 2.5%, time deposits rose by 46.4%.

TABLE 2

Average of Friday Figures		Demand liabilities (Crores of rupees)	Time liabilities* (Crores of rupees)
1950-51	..	599.13	278.45
1951-52	..	593.73	290.82
1952-53	..	546.23	309.26
1953-54	..	526.75	328.26
1954-55	..	559.62	351.86
1955-56	..	608.64	407.95
1956-57	..	653.85	453.92
1957-58	..	723.17	619.16
1958-59	..	738.10	862.80
1959-60	..	746.76	1,087.59

Although time deposits, not forming a part of the total money supply, may not have any direct bearing on the total spending in the community and as such an increase in time deposits is looked upon as an anti-inflationary factor, they are always a potential source of greater bank loans. A steady growth of such deposits enhances the power of the banks to lend. Both legally and operationally, such deposits need comparatively smaller cash balances. While the preponderance of currency in the money supply reduces the ability of the banking system to create credit on the basis of a given addition to its reserves, the increasing proportion of time deposits in the total bank deposits raises the credit-creating powers of the banking system.

The money market in India is not so well organised as in some of the industrialised countries. There is not also any organised bill market as in London or in New York⁶. The indigenous bankers such as the Shaukars and Chettiers are institutions peculiar to India, and are not to be found in the U.S.A. or in England. An important feature of the Indian money market is that it consists of two sectors—the organised sector comprising the commercial banks, co-operative banks and other

* The figures relating to deposit money given in the table on p. 3 are year-end figures whereas these are calculated by averaging Friday figures. This explains the discrepancy between the two. This however does not affect the argument.

⁶ In January, 1952, the Reserve Bank of India took steps to develop a bill market by rediscounting commercial bills at a rate lower than the Bank Rate.

ordinary financial institutions and the indigenous sector comprising the indigenous bankers and money lenders. The latter generally supply finance to the small manufacturers and traders and hence their operations are generally confined in villages and small towns. They usually combine banking with other forms of business.

In India there is no organised bill market although recently the Reserve Bank took steps to develop such a market. Most of the Indian banks used to keep the discounted bills in their portfolio till maturity. Since discounting was looked upon as a sign of weakness, the Indian banks preferred to borrow against Government securities rather than to rediscount commercial bills.

Under Section 14 of the Reserve Bank of India Act, the Bank is permitted to rediscount and to make advances to commercial banks against time bills or usance promissory notes arising out of bonafide commercial or trade transactions, bearing two or more good signatures, one of which shall be that of a Scheduled bank and maturing within 90 days from the date of advance. Till 1951, however, practically no advance was made under this provision, as time bills of exchange and promissory notes are not much in vogue in India. The major portion of advances to banks consists of cash credits, loans or overdrafts given against demand promissory notes drawn by their constituents. Borrowing by overdrafts or cash credits being less expensive and more convenient, bills in India are not very popular[†]. Moreover, with the development of branch banking in India, the bill of exchange method is less extensively used for domestic transactions than in some other countries. To impart elasticity to the credit system and to relieve stringency in the money market, the Reserve Bank of India announced in January, 1952, the scheme for the development of a bill market under the provision of section 17(4) (c) of the Reserve Bank of India Act, hitherto unused.

In these days the commercial banks in India hold also large amounts of government securities which they can either sell in the market or use as collateral against loans from the Reserve Bank. This has strengthened the liquidity position of the commercial banks as they can borrow from the Reserve Bank against these securities. In 1939 all the Indian scheduled banks taken

[†] *Trend and Progress of Banking in India*, Reserve Bank of India, 1949, pp. 47-48.

together had total investments of Rs. 360 million but by 1952 they had investments of Rs. 1,952 million in government securities besides other investments of Rs. 316 million. With the tremendous increase in the supply of short-term government securities, a market for these securities has developed during the last few years. An organised market for government securities creates greater liquidity and elasticity in the money market.

One important segment of the money market in India is the collateral loan market. About 85 to 90 percent of the loans made by scheduled banks are generally covered by collaterals like government securities, gold and silver ornaments, corporation stocks, merchandise and real estates. Collateral loans may be of three types :

- (a) Loans.
- (b) Overdrafts.
- (c) Cash credits.

As in other important money markets of the world, in India also a large portion of collateral loans is used for the financing of stock and bond purchases. Here the borrowers are usually stock brokers, although private individuals may also obtain loans against stocks and bonds. Collateral loans are generally given for longer periods than overdrafts or cash credits.

Overdraft, which is somewhat similar to the American system of "line of credit" is the right given to a customer to overdraw his account up to an agreed amount by his bank. The right to overdraw may be given against the security of stocks and bonds, or promissory notes of the customer. Cash credit is usually given against the security of commodities, either agricultural or manufactured. Before credit is granted, the commodities have to be stored in recognised warehouses. A cash credit account operates in almost the same way as an overdraft account. The difference between the two is that in the case of overdrafts securities are used as collateral, while in the other agricultural or manufactured commodities are used as collateral. In the case of cash credit, a customer is allowed a limit up to which he can overdraw. The rate of interest charged on a cash credit is generally higher than the rate charged on an overdraft.

An important feature of banking in India is the development of branch banking. But branch banking so far evolved in the country is still inadequate and is yet to be developed in the right

direction. The people living in the villages are still virtually without any banking facilities. The development of branch-banking that has so far taken place has been lop-sided because of an undue concentration of bank in large towns and cities. It is necessary that instead of opening branches at centres which are already provided with banking facilities, banks should start new branches at centres where banking facilities hardly exist. The Government of India have been greatly concerned with this aspect of the development of banking during the war period and have therefore enacted the Banking Companies (Restriction of Branches) Act, 1946, since repealed by the Banking Companies Act. The administration of this Act is expected to lead to better regional development of banking. The state Bank of India Act, passed in May, 1955, also required the State Bank to open not less than 400 branches within a period of five years in accordance with a programme of expansion approved by the Central Government.* Most of these branches are expected to be in rural areas.

Another problem arising out of the undeveloped character of India's economy is the absence of reliable and adequate statistics. Throughout the analysis in the following pages, the classical quantity theory approach rather than the modern Keynesian income-expenditure approach has been applied. The reason for this is that the data relating to the fundamental variables involved in the latter approach are far too inadequate and unreliable to be used as the basis for any generalisation. Thus the statistics available in India of income, investment and propensity to consume are hardly adequate to explain the dynamics of the price situation on the lines of Keynesian analysis. For example, a theoretical exposition of the problem of an inflationary spiral, to be reasonably adequate, must take into account a number of variables. Given the increase in the gross value of output, brought about mainly by the rise in prices, it will be necessary to know how it has affected the money earnings respectively of persons working on their own, hired work people and employers. The rise in income will have to be further analysed in terms of its effects on savings and consumption. It will also be necessary to find out the elasticity of wage rate, the relative position of

* This has already been done.

primary and supplementary costs, the relation between the profit margin and the cost of borrowing and many other functional entities. Obviously, an elaborate analysis of this sort will be impossible in Indian conditions with poor statistical information.

Moreover, it is well known that in a backward economy with resource development of a small order, the secondary and tertiary effects of an initial dose of investment and consequent employment do not necessarily follow⁸. The result is that the process of income generation through multiplier and acceleration effects, prominently visible in industrialised countries, is hardly to be seen fully in an under-developed economy. Because of the high average propensity to consume, an increase in money demand arising out of the initial primary employment brought about by new investment is mostly directed to consumption goods industries. But such industries cannot readily expand output and offer greater employment because of their inadequate reserve capacity, inelastic supply of skilled labour and dearth of capital in the economy. Thus, the income-generating process that starts with an initial increment of investment cannot go far and the growth of income is slowed down in the mid-way. In view of these difficulties, an attempt to explain the Indian inflation in terms of Keynesian tools will be of limited utility.

On the other hand, in the bottleneck situation, so prominently characteristic of a backward economy like India, the quantity theory has perhaps greater usefulness as a tool of economic analysis. The conditions underlying the quantity theory seem to obtain largely in India. In so far as currency constitutes by far the most important part of the total money supply and money is held mainly for transactions rather than for speculative purposes, monetary policy can be used for cycle control⁹, for there is, in view of the above conditions, an almost direct link between money supply on the one hand and price levels on the other. Moreover, as the existing productive capacity of the economy is small and is soon exhausted in the process of development and

⁸ V. K. R. V. Rao, *Investment, Income and the Multiplier in an Under-developed Economy*, *Indian Economic Review*, February, 1952.

⁹ A. H. Hansen, *Monetary Theory and Fiscal Policy*, p. 194; also S. C. Tsiang, *Liquidity Preference and Loanable Funds Theories, Multiplier and Velocity Analyses—A Synthesis*, *American Economic Review*, Sept. 1956, pp. 560, 564.

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the supply of real output is inelastic, the bottlenecks are reached quickly with the result that increases in money demand through new investment give rise to substantial price increases. It would not, therefore, be wrong to proceed on the basis of the assumption that in view of the inelasticity of real output, a backward economy usually exhibits the characteristics of a full employment economy in which "the quantity theory comes into its own". Monetary data are also more easily available in India than those relating to Keynesian analysis.

POST-WAR INFLATION

The end of the Second World War in August 1945 was not followed by any downward trend in prices. On the contrary, the price index continued to register increases, though the pace had slackened considerably. Between August 1945 and August 1947 when India was partitioned into two independent countries, the general price index increased by 23.4 p.c., i.e. an annual average rate of 11.7 p.c. as against an annual rate of about 24 p.c. during the six years of the war. This was due to the continuation of the inflationary pressures generated during the war time. This post-war inflationary pressure continued till December 1948, by the end of which period the latent inflationary pressures were converted, following decontrol in November, 1947, to open inflation. The subsequent period up to the beginning of the Korean War was characterised by comparative stability of prices. The price index had more or less reached a plateau where it remained till June 1950, i.e. a period of about a year and a half, with only a comparatively small ripple brought about by the devaluation of the rupee in September 1949. The Korean War brought about another upsurge in prices, and in the next 10 months, the price index rose by about 16.7 p.c. Even the impact of such a buoyant event as the Korean War had spent itself out by the end of the year 1950-51. When the first year of the First Plan started from April 1951, the price index had already touched its peak and had begun a downward journey.

So this period had three distinct phases, viz., Post-war inflation at the beginning and the Korean War inflation at the end, interspersed by comparative stability in prices with a slightly upward tilt.

The first phase : In the two post-war years before August 1947, the price index had risen by more than 11 p.c. per year. But at the beginning of the year 1947-48, the rate of increase in prices had been slowed down and between March 1947 and August 1947, the index had moved up by only 2.8 p.c. in five months. The index remained more or less steady till November

1947 when the Government of India decided to give up all physical controls over the prices and distribution of commodities, it had laboriously built up during the war years. The price index at once renewed its upward journey at a vigorous pace and by the end of 1948 the index stood at 383·6, i.e. higher by 27% over the level reached in November 1947. The following table shows the movement of prices between November 1947 and December 1948. During the thirteen months following the removal of control, the price index for food articles rose by 35%, that of raw materials by 21%, semi-manufactures by 30%, manufactured goods by 23%, miscellaneous group by 16% and the general index by 27%¹.

TABLE 1

	Food articles	Raw materials	Semi- manu- factures	Manu- factures	Miscel- laneous	General index	Cost of living Bombay
Nov. 1947	294·8	377·9	252·5	283·2	400·8	302·0	273
Dec. 1948	397·5	457·7	328·3	347·5	536·7	383·6	310

The Government decided to remove controls in the expectation that decontrol would bring the hoarded stocks to the surface and so lower prices. The advocates of decontrol might have thought, as the B. I. S. Report also observed, that the supervision of control should be elastic rather than rigid, that the price-fixing must not be such as to hamper production and that due account must be taken of the fact that the purchasing power of individual currencies had changed since 1939—not by the same percentage in all countries but everywhere to a degree which must largely be accepted in different segments of the price and cost structure². The Government's expectation of lower prices as a result of decontrol proved, however, wrong. It did not require much of a hindsight to know that this would inevitably be the case.

There were many evidences of excess liquidity of the Indian economy at that time. Employment rose after the immediate post-war decline. The average number of workers employed daily in factories subject to the Factories Act declined from the

¹ *Report on Currency & Finance, 1948-49.*

² 16th B.I.S. Report, pp. 41-43.

high level of 2.64 millions in 1945-46 to 2.26 millions in 1946-47 and then rose to 2.36 millions in 1948-49. Employment in the mines increased from 5.27 lakhs in 1947 to 5.39 lakhs in 1948³. The average annual earnings of factory employees in all industries had been rising from Rs. 619.4 in 1946 to Rs. 737.0 in 1947 and to Rs. 889.7 in 1948. The index number of money wages (1939=100) rose from 218 in 1946 to 269 in 1947 and to 322 in 1948⁴. On the basis of the recommendations of the Central and Provincial Pay Commissions, higher wages and allowances were granted to workers in factories. Similar concessions in wages and allowances were granted by private employers. The result of these concessions was seen in an increase in the average annual earnings of employees in factories by about 24% in 1947 over those in 1945. Thus in the period soon after the war, there was greater purchasing power in the hands of wage-earners whose propensity to consume is proverbially high.

The inflationary effect of larger purchasing power in the hands of wage-earners was reinforced by deficit budgeting which came to be a constant practice with the Government of India in the post-war period. In the first post-war budget the over-all deficit stood at Rs. 111.58 crores. The revised estimates of 1947-48 budget showed a deficit of Rs. 6.52 crores on revenue account and Rs. 133.41 crores on capital account. Taking the surplus of Rs. 29.24 crores on the miscellaneous head, the over-all deficit came to Rs. 110.69 crores. In the two years 1946-47 and 1947-48, the Central Government's deficit on revenue account was Rs. 51.81 crores and on capital account Rs. 194.93 crores. If the combined surplus of all provincial Governments of Rs. 17.29 crores is set off against this, the aggregate deficit during this period amounted to Rs. 229.45 crores⁵. In the 1948-49 budget, the surplus of Rs. 50.84 crores on revenue account was more than offset by the huge deficit of Rs. 167.48 crores on capital account. Likewise, the 1949-50 budget had an overall deficit of Rs. 43.80 crores. The

³ The employment index corrected for deflated cheque clearances (1935=100) rose from 122 in 1946-47 to 125 in 1947-48 and to 133 in 1948-49 (K. N. Mukherjee—*Planning and the Public Sector in an under-developed economy*—unpublished D. Phil. thesis of the Calcutta University, 1958, App. Table 4).

⁴ *Statistical Abstract for India*, 1962.

⁵ *Report on Currency & Finance, 1949-50*, pp. 182-83.

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budgetary position of the Government of India during 1946-47 to 1950-51 is summarised in the table below^a.

TABLE 2

	<i>(In crores of rupees)</i> <i>(Revised estimates)</i>				
	1946-47	(a) 1947-48	(b) 1948-49	(b) 1949-50	1950-51 Account
Surplus (+) or deficit (—) on revenue account	— 0.60	— 6.52	+ 50.84	+33.27	+59.22
Surplus (+) or deficit (—) on capital account	— 56.99	—133.41	—167.48	—80.05	—62.04
Miscellaneous (net)	— 53.99	+ 29.25	+ 34.97	+ 2.98	+15.26
Over-all surplus (+) or deficit (—)	—111.58	—110.68	— 81.67	—43.80	+12.44

Consequent on these continued deficits in the Government of India's budgets there was a corresponding expansion of money supply with the public. Between 1946-47 and 1947-48, the total money supply with the public recorded a rise of Rs. 106 crores as shown in the table below.

TABLE 3

MONEY SUPPLY IN UNDIVIDED INDIA *(In crores of rupees)*

Year	Currency with the public	Deposit money with the public	Total money supply
1946-47	.. 1,358	839	2197
1947-48	.. 1,469	894	2363

Source: *Report on Currency & Finance, 1951-52.*

The growth in money supply, it may be noted here, emanates from one or more of the three following sources: (a) budget deficits, (b) commercial bank credit and (c) surplus or deficit in the balance of payments. The last of these three sources of

^a (a) From 15th August 1947 to 31st March, 1948.

(b) Accounts of the Central Govt. not finalised.

Report on Currency & Finance, 1952-53, p. 160.

money supply namely, balance of payments, had actually been deflationary in its impact on the money supply since, for the most part of the post-war period, India's balance of payments had considerable deficits. But during this period, expansion in scheduled bank credit had an important role in influencing the growth of money supply. So far as the commercial banks got a part of the money put into circulation by deficit budget operations and were thus in a position to expand credit on the basis of their augmented reserves, deficit budgeting itself gave an impetus to the increase in scheduled bank credit. It will be clear from the table⁷ below that the total of scheduled bank credit rose from Rs. 427,11 lakhs in 1946-47 to Rs. 441,29 lakhs in 1948-49.

TABLE 4

INDIAN UNION

Year	Total of scheduled bank credit (In lakhs of rupees)		Percentage of bank credit to total demand and time liabilities
1945-46	..	Rs. 301.12	32.94
1946-47	..	" 427.11	40.70
1947-48	..	" 444.36	42.30
1948-49	..	" 441.29	45.10
1949-50	..	" 442.09	50.79

Thus, before and during the decontrol period, there were increased employment, higher rates of earnings of wage-earners, continued deficits in Central Government budgets accompanied with a substantial increase in scheduled bank credit leading to some expansion of total money supply with the public. All these factors made for increased purchasing power at the disposal of the public. But the situation on the production front was rather depressing. Against the expansion of money supply and of purchasing power of the people, there was actually a decline in the output of goods, both agricultural and industrial. The production of food-grains, finished steel, cotton piece goods, and

⁷ *Report on Currency & Finance, 1949-50*, p. 164. Though the total bank credit seems to have declined as between 1947-48 and 1948-49, this is not so because the 1947-48 figures related to India as a whole as it existed before 1947, and the next year's data related only to the Indian Union.

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cement, etc. to name only a few of the essential commodities, recorded a decline.

TABLE 5

Commodities			Output	
			1945	1948
Food-grains (000 tons)	..	..	46,093	44,393
Finished steel (000 tons)	..	..	954	854
Cotton piece goods (million yards)	..	..	4,711	4,319
Cement (000 tons)	..	..	2209	1,553

No wonder that the policy of decontrol would be a failure in such a situation. In a scarcity economy possessed of excess liquidity, the policy of decontrol only resulted in hectic speculation in commodity markets and thus intensified the inflationary pressure. The extent of the price rise consequent on the decontrol measure is illustrated in the table below^a:

TABLE 6

		Food articles	Raw materials	Semi- manufac- tures	Manufac- tures	Misce- llane- ous	General index
Nov. 1947		294.8	377.9	252.5	283.2	460.8	302.0
July 1948		390.7	449.9	338.2	370.2	537.3	389.6

During the eight months following the removal of control in November 1947, the general index advanced continuously until it touched a new peak level of 389.6 in July 1948, an increase of 29 p.c. This rise was all round, all the constituent group indices showing increases. There was a 32.5 per cent rise in food articles, 19.1 per cent in raw materials, 33.9 per cent in semi-manufactures, 30.7 per cent in manufactured goods, and 16.6 per cent in the miscellaneous group.

Thus it is clear that the rate of increase in prices in three out of five broad sectors into which the Indian price index has been divided has been more or less uniform. It is in the sectors—industrial raw materials and miscellaneous groups—that the rise has been much less than that recorded in those three sectors.

^a *Report on Currency & Finance, 1948-49.*

The reasons for such difference in sectional price movements would be discussed in Chapter V.

This indicates that the pressure of the control measures was quite significant in the three important sectors, food-grains, semi-manufactures and manufactured goods, while it was comparatively lax or absent in the miscellaneous group with the result that the price indices in that group had already registered significant increases even before the withdrawal of control measures. With respect to industrial raw materials, one favourable factor responsible for the lower rate of increase in prices was the rise in the index of production of non-food crops adjusted for population growth from 84.7 in 1946-47 to 87.1 in 1947-48*. The index of commercial crop production (1935-36=100) also rose from 102 in 1946-47 to 105 in 1947-48. There was at the same time virtually no increase in industrial production, the index of industrial activity (1935=100) declining from 166 in 1945-46 to 156 in 1946-47 and 155 in 1947-48. The increase in output and the almost stagnant demand from manufacturers for raw materials could provide some explanation for the comparatively slower rate of increase in their prices.

The period of decontrol served to bring the latent inflation into the open causing the prices to rise to the level where inflationary pressures seemed to have been exhausted. The Government of course re-introduced some control measures and adopted a number of anti-inflationary weapons which included, among others, such measures as reduction of Government expenditure, a larger flow of imports and stimulating internal production. But in previous years prices continued rising in spite of such control measures. The general index of prices after touching the maximum in December 1948 declined by 3.5% in the 4 months and then registered an increase by about 5 p.c. in the next six months. Then came the devaluation of the rupee in September 1949 when its value was cut down by 30 p.c. in terms of dollar. Even this strong inflationary measure did not raise prices to the extent anticipated and by the end of December 1949, the general index had actually declined to 381.3 from 383.6 twelve months before. By the second week of June 1950 on the

* A. R. Sinha. The Trend of Agricultural Production in India during the Last Thirty years—A Preliminary Study with some observation on the Food situation in the country. *Bulletin of the International Statistical Institute*, Vol. XXXIII, Part V, p. 210. Similar index for food production adjusted for population growth remained stationary in these two years.

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eve of the outbreak of the Korean War, the price index had risen to only 395.6 i.e., by only 3 p.c. in course of 18 months which witnessed a substantial devaluation of the currency. The following table illustrates the movements of the price indices during the post-decontrol phase, the post-devaluation period and the post-Korean phase.

TABLE 7

	Food articles	Raw materials	Semi- mann- factures	Manu- factures	Misce- llaneous	General index
December 1948	397.5	457.7	328.3	347.5	536.7	383.6
March 1949	376.5	462.8	322.4	329.4	515.2	370.2
August (1949) (1)	410.6	460.5	330.8	348.6	541.6	389.0
March 1950 (2)	396.2	490.1	338.2	347.4	630.6	392.4
Devaluation rise % increase (+) or decrease (-) of 2 over (1)	-3.5	+6.4	+2.2	-0.3	+16.4	+0.9
June 1950 (3)	402.8	490.7	335.5	347.6	692.0	395.6
March 1951 (4)	412.0	608.9	381.4	387.2	753.4	438.6
Post-Korean War rise—% increase (+) or decrease (-) of 4 over 3	+2.3	+24.1	+13.7	+11.4	+8.9	+10.9

Source: *Reports on Currency & Finance, 1949-50, 1950-51.*

The prices of food-grains had virtually remained steady as well as those of manufactured goods and it was only the price index of industrial raw materials that registered an increase of a little more than 7 p.c. That also took place substantially after devaluation which led to some considerable increase in the export price index. The comparatively slower rate of rise in the Indian price level after devaluation was probably due to the fact that the inflationary pressures had already spent themselves out some months before the occurrence of that event.

There were also other evidences of the exhaustion of inflationary pressures in the Indian economy. For the first time since the beginning of the war, total money supply in the Indian Union did not increase in 1948-49 and 1949-50. On the contrary, money supply declined by Rs. 43.3 crores in 1948-49 and by Rs. 18.4 crores in 1949-50 in spite of budget deficits. This is to be largely explained by the fact that since the beginning of 1946 right up to the last quarter of 1949 balance of payments consistently

showed deficits. This large adverse balance of payments had a moderating influence on the inflationary pressure brought into being by continuous budget deficits.

The normal seasonal trends in money supply which were swamped during the war time by the vast increases in money supply reappeared during these years. The contraction in money supply during the slack season of 1949 (April to September) amounted to Rs. 121.2 crores against a contraction of only Rs. 35.0 crores in the slack season of 1948 when the economy was passing through the buoyancy of decontrol. The index numbers of the prices of Government and semi-Government securities (Index 1938=100) declined from 103.4 in December 1948 to an average of 102.3 during 1949 and finally to 101.4 in May-June 1950, the average yield of 3% rupee paper (undated) rising from 3.02% in December 1948 to 3.08% in June 1950. The price index of variable dividend industrial securities (base 1938=100) declined from 178.6 to 112.9 during the same period and even the impact of devaluation failed to give an upward thrust to their prices.

Another evidence of the exhaustion of inflationary pressure was to be found in the comparative steadiness in the price of gold—the average of closing quotations, after rising continuously every year from 1932-33 reached a peak at Rs. 114.9 and remained almost at that level throughout 1949-50. One more evidence is furnished by the figures for the total of cheque clearances which was the lowest (Rs. 6209.94 crores) in 1949-50 as against Rs. 6638.11 crores in 1948-49.

One important factor in the maintenance of stability was the increase in food production that took place in 1948, 1949 and 1950 over the levels in 1946 and 1947. Production of cereals rose from 4.21 million tons in 1947 to 4.41 million tons in 1948 and 1949 and to 4.58 million tons in 1950. Output of rice registered substantial increases both in 1949 and 1950 when it rose from 1.96 million tons in 1948 to 2.17 million tons in 1949 and to 2.19 million tons in 1950. The result was a decline in the prices of cereals which fell from 467 in March 1949 to 454 in March 1950.

Budgetary policy also proved to be of some help. Whereas there were considerable deficits in the combined budgets of the Central and State Governments both during 1947-48 and 1948-49,

the amount of deficit declined in 1949-50 and in the next year there was actually a surplus.

Persistent deficits in the balance of payments since the beginning of 1946 up to the last quarter of 1949, had, as already stated, a moderating influence on the inflationary pressure during this period. During the devaluation phase, in the twelve-month period, October 1949 to September 1950, the foreign assets held by the Reserve Bank showed a rise of about Rs. 30 crores and money supply in the country went up by Rs. 23 crores against a fall of foreign assets of Rs. 242 crores and contraction of money supply of Rs. 120.5 crores in the preceding twelve months. But the inflationary effect of this balance of payments surplus was largely modified by the increase in Government balances with the Reserve Bank, which was of the order of Rs. 18 crores during this period.

Though spectacular, the effect of devaluation proved to be short-lived. The favourable trend in the balance of payments that commenced in the last quarter of 1949 continued into the first quarter of 1950 but in the second quarter of 1950 there was again a deficit of Rs. 19.2 crores. The following table gives a picture of India's balance of payments position from 1947 to 1951. The consistent deficits in the balance of payments were clearly reflected in the rate of expansion of money supply since the end of the war. Leaving aside the substantial decline in defence expenditure, the only other important factors responsible for the slower rate of expansion in money supply were continued adverse balance of payments and the anti-inflationary policy of the Government. The rate of expansion in money supply revealed a tendency to decline which continued with some minor aberrations till 1950. The annual rate of expansion of currency came down to 2% in 1946-47 from 12% in 1945-46 and 23% in 1944-45. In 1947-48, there was a reversal of this tendency due partly to heavy Government expenditure on refugee relief, defence and food subsidies. The total currency absorption in that year stood higher at Rs. 51 crores against Rs. 31.11 crores in the previous year. Figures relating to the year 1948-49 for the Indian Union are not available. Taking the figures for the Indian Union and Pakistan together, it is found that demand deposits declined from Rs. 706.65 crores in 1947-48 in undivided India to Rs. 674.56 crores in 1948-49 in the Indian Union. In fact, 1948-49 was the first year

TABLE 8
INDIA'S BALANCE OF PAYMENTS—CURRENT TRANSACTIONS^b
(In crores of rupees)

Year				Net surplus (+) or deficit (—)
1947				-154
1948	1st Quarter	..	..	+ 16.1
	2nd "	..	..	+ 16.7
	3rd "	..	..	- 82.7
	4th "	..	..	- 45.9
	Total	..	..	- 96.0
1949	1st Quarter	..	..	-102.1
	2nd "	..	..	- 78.6
	3rd "	..	..	- 29.5
	4th "	..	..	+ 42.6
	Total	..	..	-167.6
1950	1st Quarter	..	..	+ 30.5
	2nd "	..	..	- 19.2
	3rd "	..	..	+ 10.5
	4th "	..	..	+ 48.2
	Total	..	..	+ 70.1
1951	1st Quarter	..	..	+ 22.0
	2nd "	..	..	+ 11.7
	3rd "	..	..	- 14.2
	4th "	..	..	- 50.8
	Total	..	..	- 31.3

when there was a net contraction of currency since 1938-39¹⁰. The net decrease in money supply for the Indian Union alone in 1948-49 has been estimated at Rs. 43.26 crores¹¹. The return of currency in the slack season of 1949-50 was the largest seasonal contraction on record—Rs. 130.30 crores. This may be attributed partly to the liberalisation of import controls in 1948 which gave rise to a deficit in the balance of payments and substantial net sales of sterling by the Reserve Bank. The large absorption of currency in the busy season of 1949-50, the effect of an export surplus and purchase of sterling following devaluation

^a Post-war Balance of payments in India, *Reserve Bank of India Bulletin*, July 1949 and June 1956. *India's Balance of Payments*, (Reserve Bank of India). Figures for 1947 relate to undivided India; those for 1948-51 exclude Pakistan.

¹⁰ *Report on Currency & Finance, 1949-50*, p. 128.

¹¹ *Report on Currency & Finance, 1953-54*, p. 115.

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was less than the return of currency in the previous slack season so that over the year as a whole there was a net contraction of money supply with the public. Seasonal variations of money supply are given in the table below :

TABLE 9
SEASONAL VARIATIONS IN MONEY SUPPLY
(In crores of rupees)

1. Slack Season	2. Busy Season	Currency with the public	Demand liabilities (a)
1946-47	1. April to Sept.	- 31	+47
	2. Oct. to March	+ 54	-67
1947-48	1. April to Sept.	- 68	+18
	2. Oct. to March	+130	+50
1948-49	1. April to Sept.	- 55	+19
	2. Oct. to March	+ 47	-57
1949-50	1. May 13 to Oct. 28	-125	- 6
	2. Oct. 28 to May 12	+122	-13
1950-51	1. May 12 to Sept. 29	-100	+13
	2. Sept. 29 to May 11	+207	+ 9

(a) Up to 1948-49 inclusive of inter-bank deposits ;

Source : *Reports on Currency & Finance*, 1949-50, p. 243 ; 1950-51, p. 153.

Korean War Inflation

The outbreak of the Korean War in June 1950 naturally disturbed the stability attained in the Indian price level. From the point of view of its inflationary effect, devaluation spent its force in the first quarter of 1950. The rate of increase in the general price level since the second quarter of that year is to be explained by the Korean War which created a sudden burst of demand arising out of a rush for stockpiling of essential goods and adoption of re-armament programmes on a world-wide scale. Almost overnight, producers, dealers and consumers alike became alive to the potential threats and no longer thought it advisable to postpone purchases in anticipation of a downward adjustment of prices.

Secondly, there was the feeling that the conflict in Korea might spread further afield and obstruct the production and shipments from the rich producing regions in S. E. Asia—the source of nine-tenths of the world's natural rubber supply, two-thirds of

its tin, two-fifths of its wolfram and smaller proportions of a wide variety of other materials.

In the third place it came to be realised that with the initiation of the major defence programmes, there would be competition between military and civilian needs. This realisation induced purchases in anticipation of further demand. All these factors naturally brought an upsurge in Indian prices but during the Korean episode, the rate of increase in prices that took place in India was slower than that in a number of other countries. Thus, in the U.S.A., the price index rose from 95 in June 1950 to 112 in March 1951, i.e., by 18%, in the U.K. by 22%, by more than 28% in Australia, 16% in Canada and about 11% in India. The uptrend in prices continued after April 1951 in Australia, the U.K., South Africa and a number of other countries while in India prices started a downward course from that month. All this is illustrated in the following table :

TABLE 10
INDEX NUMBERS OF WHOLESALE PRICES

	U.S.A.	U.K.	Canada	Australia	South Africa	India
	Base : 1948=100					Base : 1939=100

June 1950	95	117	108	131	114	395.6
July "	99	119	110	131	114	405.2
August "	101	120	112	136	115	409.2
September "	103	124	115	137	116	412.5
October "	103	127	114	139	116	411.2
November "	105	132	115	143	117	410.9
December "	107	133	116	143	119	412.6
January 1951	110	137	120	146	120	414.3
February "	112	139	123	152	121	423.4
March "	112	143	125	161	123	438.6
April "	111	145	125	158	124	457.5
May "	111	146	125	160	128	456.8
June "	110	146	125	166	130	456.5
July "	109	146	126	166	130	447.0
August "	109	148	125	173	132	437.6

Sources : *International Financial Statistics* issued by the I.M.F.; *Report on Currency & Finance*, 1952-53.

It provides another evidence to show that the full impact of post-war inflationary pressures was already spent by the end of 1948 and but for the devaluation of the rupee and the outbreak

of the Korean War prices would probably have begun their downward course in this country. That this would have been the case would be obvious from another fact that the domestic-induced inflationary pressure had usually given an upward thrust to the price in gold. But the annual average of the closing prices of gold declined by more than 1.2% in 1950-51 from the level reached during 1949-50. The annual average market price of silver reached the peak during 1948-49 (Rs. 177-9 per 100 tolas gross) and then declined to—Rs. 174-11-10 in 1949-50. The Korean War represented the last lap in the uptrend in prices since the end of the Second World War. The rate at which prices rose during the first phase of the Korean War had a parallel in the rate of rise subsequent to decontrol in 1947, the rate of increase in the two phases being respectively about 16% and 21% in the ten-month periods July 1950 to April 1951 and November 1947 to August 1948. But the factors initiating the rise in these two periods were widely different. In 1947, the spurt in prices was mostly due to domestic factors while during the Korean phase external factors were more dominant. In many countries, the price rise became spectacular and disturbing and considered against the extent of price rise in other countries, the spurt in India was largely a sharing of the general experience outside.

Chapter II

RETREAT FROM CHEAP MONEY POLICY

The recession in prices from the Korean peak was started by such factors as (a) increased supply of several agricultural products, particularly cotton, (b) decline in the demand for raw materials on the part of industries following as a reaction of the excessive over-stocking of such goods during the Korean flare up, (c) Korean peace-move in mid-1951, the stretching out of the rearmament programme in the U.S.A. and lastly (d) the arrangement for orderly sharing of the scarce materials through the International Materials Conference. These factors combined together to slacken the demand in the U.S.A. for most of the industrial raw materials and this reacted on the prices in other countries.

In India, the rate of decline was rather slow during the earlier part of the recession. Thus the general index declined by about 5.6% from the peak of 462.0 on the 14th April 1951 to 436.2 on the 29th October 1951, the month before the adoption of the new monetary policy. The decline became precipitated since January 1952 when the full impact of the rise in the Bank Rate and the change in the Open Market Policy began to be felt. By the middle of March 1952, the general index recorded a fall of 15% from 428.8 on 26th January to 364.9 on the 15th March. The behaviour of prices during 1951-52 is illustrated in the following table :

TABLE 1
INDEX NUMBERS OF WHOLESALE PRICES 1951-52

		Food articles	Industrial raw materials	Semi- manu- factures	Manu- factures	Miscel- laneous	General index
14th April	1951	414.3	699.8	390.1	413.1	789.1	462.0
26th May	"	413.8	689.8	388.2	411.4	724.6	458.1
30th June	"	409.5	675.4	382.5	406.3	724.3	452.1
28th July	"	409.0	621.3	377.6	404.8	728.1	445.9
28th Aug.	"	406.7	569.0	374.5	393.6	731.1	431.9
29th Sept.	"	414.1	576.9	371.5	401.7	711.2	436.9
29th Oct.	"	403.6	586.6	378.1	401.0	730.8	436.2
24th Nov.	"	399.8	576.2	376.0	401.5	761.4	434.1
29th Dec.	"	400.6	573.6	370.4	400.3	745.9	432.2
26th Jan.	1952	392.3	573.8	370.1	399.4	734.5	428.8
23rd Feb.	"	363.5	527.6	359.2	392.2	700.3	407.4
15th March	"	335.2	382.8	339.0	376.6	610.8	364.9

Source : *Report on Currency & Finance, 1951-52. Statement 16.*

Let us discuss the monetary measures that had been adopted during this period. The practice adopted by the Reserve Bank during the war years of giving continuous support to Government securities was continued in the post-war period also. To maintain interest rates at a low level, the Reserve Bank consistently gave price support to Government securities by making open market purchases. This is reflected in the increase that took place in the Bank's 'investments' which rose from Rs. 24.65 crores in 1945-46 to Rs. 96.04 crores in 1949-50.

TABLE 2

Average of Friday Figures			Investments in the Banking Department ¹ (In crores of rupees)
1945-46	..	..	24.65
1946-47	..	..	31.70
1947-48	..	..	81.53
1948-49	..	..	75.65
1949-50	..	..	96.04

These open market purchases by the Reserve Bank supplied the scheduled banks with additional reserves on the basis of which they could lend larger sums to their customers. It may be noted in this connection that such an expansion of loans by the scheduled banks was not accompanied by an increase either in their excess reserves or in their demand deposits. The explanation is to be found in the fact that with greater facilities for accommodation by the Reserve Bank, the scheduled banks could

¹ Report on Currency and Finance, 1951-52.

It may be noted here that the mere fact of an increase of the Reserve Bank's holding of Government securities may not always indicate the extent of the Bank's 'Open Market Purchases' as a control technique. This is because the Bank often buys securities for purposes other than the objective relating to the traditional 'Open Market Purchases' and because these purchases are shown in the Bank's account not by an increase in the amount of securities held but by a reduction in Government deposits. Nevertheless, the visible purchases were quite attractive of one's attention. Besides the sharp rise in the amount of 'investment', the variations in their volume had been wide and striking. Moreover, during the years 1946-49, the relative stability of the gilt-edged market against the sharp decline in the prices of industrial securities, both of the fixed and of the variable categories is to be largely explained by the continuous support given by the Reserve Bank to Government securities. Between 1946-47 and 1949-50 the index number of Government securities declined by only 3.3% from 101.7 to 101.2 while during the same period the index number of fixed industrial securities declined from 140.6 to 101.9 or by 27.5% and that of variable yield securities from 252.5 to 115.4 or by 53.6%. (Report on Currency & Finance, 1951-52, p. 190).

carry on with smaller reserves and whatever additional funds they came to possess were readily used in making loans and advances for which there was a persistent demand due to strong inflationary situation and greater speculative trading within the country. The figures relating to the total of scheduled bank credit, the volume of excess reserves and demand and time deposits are given below :

TABLE 3
REQUIRED STATUTORY RESERVES AND EXCESS

Reserves of Scheduled Banks (In millions of rupees)			
Year	Scheduled Banks' total balance with the Reserve Bank	Required or statutory reserve	Excess balance or excess reserves
1946 ..	850	420	430
1947 ..	960	420	540
1948 ..	860	400	460
1949 ..	660	350	310
1950 ..	620	360	260
1951 ..	590	360	230

Source : K. C. Chacko, *Monetary and Fiscal Policy of India*, p. 37.

TABLE 4
(In crores of rupees)

Indian Union			
Average of Friday figures	Demand deposits	Time deposits	Total of Scheduled Bank credit ²
1946-47 ..	725.54	323.11	427.11
1947-48 ..	706.65	343.89	444.36
1948-49 ..	674.56	303.88	441.29
1949-50 ..	597.79	272.59	442.09
1950-51 ..	599.13	278.45	458.90

The figures given above clearly show the impact of cheap money policy on the volume of scheduled bank credit which, in its turn, had naturally a great influence on the inflationary situation in the country. It is thus clear that during the period 1947-51, in the fight against inflation reliance was placed on fiscal measures and physical controls only. No need was felt for a retreat from the cheap money policy of giving unqualified support to the securities market. It was hardly a desirable policy

² Reports on Currency and Finance, 1949-50, 1952-53.

at a time when the inflationary situation was aggravated externally by re-armament drive and stock-piling boom in the U.S.A. and internally by a scarcity of goods in general.

But a retreat from cheap money policy had already started in the immediate post-war period in a number of countries which had to deal with inflationary situations. For example, in France, a number of quantitative restrictions were introduced in order to check the current inflationary trends. The rates charged by the Bank of France were raised, commercial credits were affected and banks charged rates that varied at one time from 7 to 9 percent for loans to industrial customers. Long-term rates were also raised, the yield of 3% rates rising from 4.48% in December 1947 to 4.67% in September 1948 and 5.18% in February 1950.

In the U.S.A. the change from December 1946 to March 1948 was $\frac{1}{4}$ % and was designed to make member-bank borrowing expensive. The fixed buying rates for Treasury Bills at $\frac{3}{8}$ th% was stopped in July 1947. The chief cause of the upward adjustment of interest rates was that there was a strong demand for funds in excess of the supply of savings available for investment and the resultant pressure of demand for bank credit and hence on the liquid position of banks³.

A noteworthy feature of the monetary policy of the Federal Reserve System was its flexibility. Whenever required, the Federal Reserve Authorities did not hesitate to tighten up credit but as soon as the situation altered, they were equally prompt in relaxing controls. Thus a policy of mild restraint during July-December 1951 was followed by a policy of creating easy money conditions which lasted from May 1953 to June 1954. After this, the Authorities showed a more or less neutral attitude during July 1954 and March 1955 which was again followed by a policy of mild restraint after April 1955⁴.

In the U.K. also, the same trend was visible. The price of $2\frac{1}{2}$ % Treasury Stock which had stood at par in October 1946 declined to 80 in July 1947 and to 75 in April 1948. Flexible market rates for long-term Government securities came to be accepted in the London market in 1949 and a new level of 3.6 to 3.8% was reached at which operations took place without any artificial official support.

³ *Eighteenth Report of the B.I.S.*, p. 125

⁴ *Twenty-fifth Report of the B.I.S.*, p. 152.

Not only in the U.K., U.S.A. and France, but in a number of other countries monetary policy came to be relied upon as a measure to secure economic stability. Germany, Netherlands, Norway, Sweden, Denmark and Belgium—in each of these countries there were Bank Rate changes accompanied with open market operations, changes in reserve requirements, moral suasion and sometimes regulation of hire purchase finance. The success of monetary policy was not of course uniform in all countries for, it was necessarily determined to a large extent by the special circumstances obtaining in different countries. But there was no doubt that the rising trends of prices, credit and money supply were more successfully checked in the countries using monetary device firmly and promptly than in those which did not adopt any monetary control.

Thus, a retreat from the cheap money policy was to be found almost all over the world in the immediate post-war period. Of course, there might not be a definite swing back to a dearer money policy in all countries, but not the rigid pursuit of a cheap money policy either. The appropriate expression would rather be a flexible interest rate policy. As the B. I. S. Report states, there was an increasing tendency in many countries to follow a flexible interest rate as an important part of a smoothly working economic system⁵.

In India, the retreat came much later in November 1951, though the published statements of the Reserve Bank of India showed that the policy of raising the Bank Rate had already been decided upon in July-August 1951, to be given effect to from the beginning of the next busy season. In November 1951, the Reserve Bank for the first time since its inception, raised the Bank Rate from 3% to 3½% and made the announcement that except in special circumstances it would abstain from buying Government securities to meet the seasonal requirements of banks but would as a normal practice advance money at the prevailing Bank Rate on Government and other securities specified in Sec. 17(4)(a) of the Reserve Bank of India Act. This meant a gradual retreat from the cheap money policy.

⁵ *Twentieth Report of the B.I.S.*, p. 221.

The rise in the Bank Rate and the declared change in open market policy which was fully in keeping with the world trend had an immediate impact on the money market. The rise in the Bank Rate was followed by a rise in other rates also prevalent in the market. The Imperial Bank raised the general lending rate from 4% to 4½%, the call rate for advances to banks against Government securities of Rs. 5 lakhs and above from 2¾% to 3% and for amounts less than Rs. 5 lakhs from 3% to 3¼%. With the progress of the season, the call money rates of the larger scheduled banks hardened and the Imperial Bank further raised the rate of advances of Rs. 5 lakhs and above to banks against Government securities to 3½%. With this increase, the Imperial Bank's rate on advances became equal to the Bank Rate with the result that it was no longer cheaper for the commercial banks to borrow from the Imperial Bank rather than the Reserve Bank⁶.

Of course, the rise in the Bank Rate by itself could not increase the Reserve Bank's control on the supply of money and credit if the Bank continued to purchase Government securities as readily as it had done in the past. Bank's withdrawal of ready support to the securities market resulted in a sharp fall in the prices of such securities. The index number of Government of India securities (base : 1938=100) declined from 98.0 for the week ended November 10, 1951 to 92.7 during the week ended December 1, i.e., by about 5% in less than a month⁷.

Thus the scheduled banks were put under pressure from two directions. The fall in security prices placed them in a difficult position as they had to value the securities in their portfolios at market prices for balance-sheet purposes. Secondly, they could not raise funds from the market by selling securities in a falling market ; nor could they raise additional reserves by selling securities to the Reserve Bank. The only way left open to them to meet the rising demands of the coming busy season was to borrow from the Reserve Bank or the Imperial Bank at higher

⁶ *Report of the Central Board of Directors, Reserve Bank of India, June 30, 1952, p. 15.*

⁷ *Report of the Central Board of Directors, Reserve Bank of India, June 30, 1952, p. 19.*

rates. The result was a hardening of interest rates in the organised sector of the economy.

Figures obtained from surveys of bank advances conducted by the Reserve Bank indicate that between December 1951 and March 1952 the advances made by scheduled banks for commercial purposes rose by only Rs. 5.8 crores as against an increase of Rs. 64.1 crores in the corresponding quarter of the previous year. Industrial advances showed a much smaller variation, advances rising by Rs. 38.0 crores in the first quarter of 1952 as against Rs. 43.8 crores a year earlier⁸. The change in the total of bank credit was also remarkable. Bank credit which decreased by Rs. 85.86 crores in the slack season i.e., between May 11, 1951 and October 26, 1951, increased by only Rs. 99.96 crores between October 26, 1951 and March 7, 1952. This expansion was much smaller than the rise of Rs. 180.29 crores between November 24, 1950 and May 11, 1951.

Thus by and large, the new monetary policy fulfilled the immediate objectives of preventing a large expansion of money supply during the busy season and of enabling the Reserve Bank to have more effective control on the volume of bank advances. The diminution in the volume of credit restricted the scope of speculative trading which, in its turn, had its impact on the down-trend in prices.

In the meantime, the recession in prices begun from May 1951 gathered momentum from the end of December 1951. The decline in prices, it may be observed here, was larger in India than in other countries. In the months following April 1951 up to March 1952, prices in India fell by 17.5% as against 2.7% in the U.S.A. and a rise of 4.8% in the U.K., as shown in the table below :

TABLE 5

INDEX NUMBERS OF WHOLESALE PRICES IN INDIA, THE U.S.A. AND THE U.K.

U.S. Base : January-June 1960=100⁹

		India	U.S.A.	U.K.
1951 2nd Quarter	..	116	117	129
1951 3rd Quarter	..	113	116	130
1951 4th Quarter	..	112	116	133
1952 1st Quarter	..	104	114	134

⁸ *Ibid.*

⁹ *International Financial Statistics*, 1952.

This is to be largely explained by the predominantly agricultural character of India's economy. It is well known that a striking feature of primary production is that the elasticity of supply in response to changes in prices is inverse. Although the sale proceeds decline with the fall in prices and the margin between prices and costs becomes narrower, production does not diminish either at all or proportionately to the fall in prices; possibly the primary producer seeks a compensation in volume for what he loses in value. Excessive dependence on agriculture, absence of any large-scale industrialisation throughout the country and virtual non-existence of tertiary industries made the decline steeper in India.

In view of the progressive rate of decline in prices in the months following April 1951, the Reserve Bank ultimately had to come to the aid of the market to moderate or arrest the rate of decline. In January 1952, the Reserve Bank introduced the Bill Market Scheme under which provision was made for the supply of busy season finance with the assurance that money so lent would be automatically returned to the Bank within three months—a survival of the belief that money lent against self-liquidating bills of exchange would not be inflationary. It was also conceived with an idea to provide some relief to banks from the rigours of the new monetary policy. Under the scheme, advances were granted to scheduled banks having deposits of not less than Rs. 10 crores under Sec. 17(4)(c) of the Reserve Bank of India Act on the security of usance promissory notes of their constituents. Thus, the new policy ensured that advances granted by the Bank were for bonafide trade purposes and for short periods.

PERIOD OF RELATIVE STABILITY

(MARCH 1952—MAY 1955)

The monetary policy introduced in November 1951 continued till the end of the First Five Year Plan. What was the behaviour of prices during this period covering the major part of the First Plan period?

The decline in prices that was started with the Korean peace-move in mid-1951 and was precipitated by the restrictive monetary policy of November 1951, was arrested after March 1952. In the last two weeks of March 1952, prices tended to recover from the precipitate decline of the last two months of 1951-52. In fact, from March 1952 to March 1953, prices in general rose by 2.0%, although the average price-level for 1952-53 as a whole was still 12.4% less than that of 1951-52. The general trend of prices during 1952-53 which was relatively free from the fluctuations noticed since the outbreak of the Korean War is illustrated in the following table¹.

TABLE 1

Commodity groups	March 1952	March 1953	Per- centage change of 2 over 1	1951-52	1952-53	Per- centage change of 5 over 4
	(1)	(2)	(3)	(4)	(5)	(6)
Food articles ..	342.7	365.0	+6.5	398.6	357.8	-10.2
Industrial raw materials ..	424.2	453.1	+6.8	591.9	436.9	-26.2
Semi-manufactures ..	343.2	349.8	+1.9	374.4	343.8	-8.2
Manufactures ..	383.8	369.0	-3.9	401.5	371.2	-7.5
Miscellaneous ..	625.6	585.5	-6.4	721.6	614.1	-14.9
General index ..	377.5	385.2	+2.0	434.6	380.6	-12.4

During 1953-54, prices remained fairly steady, recording a rise of only 2.3% over those in March 1953. The general index at the end of March 1954 was 394.0 as against 385.2 in March 1953. Broadly speaking, the two years 1952-53 and 1953-54 were marked

¹ *Report on Currency and Finance, 1952-53*, p. 37.

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by a comparative stability of prices, the total rise in the general index in these two years being of the order of only 4%.

This period of relative steadiness in prices was followed again by a resumption of the downtrend in 1954-55. The fall was particularly marked during the second half of the year and the Government had to support certain prices at a minimum level. The main trends of prices during 1954-55 may be seen in the following table :

TABLE 2

	Food articles	Indus- trial raw materials	Semi- manu- factures	Manu- factures	Miscel- laneous	General index
March 1954 ..	371.4	462.5	355.8	373.9	686.9	394.0
March 1955 ..	297.0	412.7	333.5	376.3	553.3	353.8
Percentage change	-20.0	-10.8	-6.3	+0.6	-19.4	-10.2

Throughout the year, the price indices were lower than in the previous year and the general index for March 1955 was lower than the March 1952 slump figure. This downward course persisted till early June 1955 when the general index declined to 340.6, the lowest since March 1948. After this, there was a reversal of the downtrend which continued throughout the year 1955-56 and by the end of December 1955 the general index rose by 8.0% and by March 1956, it rose by 13.7%. But it may be observed here that despite the sustained rise for six months from June to December 1955, prices of almost all groups of articles touched only the December 1954 level so that it is only the rise during January-March 1956 that indicates the real rise that took place over the year 1955-56. This is illustrated in the following table :

TABLE 3

	Food articles	Indus- trial raw materials	Semi- manu- factures	Manu- factures	Miscel- laneous	General index
Dec. 1954 ..	318.0	436.3	347.4	375.1	579.7	367.8
4th June 1955 ..	276.9	386.2	330.9	371.0	574.8	340.6
Dec. 1955 ..	323.7	438.3	346.6	373.0	544.2	368.4
March 1956 ..	351.6	475.6	369.4	374.8	508.1	387.3

Thus, price-movements during the First Plan period reveal several distinct phases. The decline started since mid-1951 was

arrested after March 1952 ; this was followed by a short boom as shown in the rise in prices from March 1952 to March 1953 ; then a period of relative steadiness in prices during 1953-54 which was followed again by a recession lasting up to June 1955 after which there was a reversal. These booms and recessions were however not deep enough to produce large fluctuations in prices so that over the First Plan period as a whole there was comparative stability of prices. Considered in the context of several factors, the behaviour of prices was remarkable. Firstly, there was the impact of the development expenditure and some deficit financing. The actual outlay in the First Plan was Rs. 1960 crores and the amount of deficit financing was as much as Rs. 420 crores².

Secondly, the balance of payments deficit was never large enough to force a substantial deflation of currency. The following table summarises India's balance of payments position from the first quarter of 1951 to the first quarter of 1956.

TABLE 4
INDIA'S BALANCE OF PAYMENTS—CURRENT TRANSACTIONS
(In crores of rupees)

Year				Net surplus(+) or deficit (-)
1951	1st Quarter	..	..	+22.0
	2nd "	..	..	+11.7
	3rd "	..	..	-14.2
	4th "	..	..	-50.8
	Total	..	..	-31.3
1952	1st Quarter	..	..	-75.4
	2nd "	..	..	-5.4
	3rd "	..	..	+11.4
	4th "	..	..	+32.0
	Total	..	..	-37.4
1953	1st Quarter	..	..	+14.1
	2nd "	..	..	-10.4
	3rd "	..	..	+0.8
	4th "	..	..	+52.4
	Total	..	..	+56.9

² Review of the First Five Year Plan, pp. 3, 35.

TABLE 4—Continued
INDIA'S BALANCE OF PAYMENTS—CURRENT TRANSACTIONS
(In crores of rupees)

Year				Net surplus(+) or deficit (—)
1954 1st Quarter	..	..	..	+18.9
2nd "	..	..	..	—14.6
3rd "	..	..	..	—14.8
4th "	..	..	..	+10.5
		Total	..	0.0
1955 1st Quarter	..	..	..	+27.2
2nd "	..	..	..	—
3rd "	..	..	..	— 0.5
4th "	..	..	..	+16.6
		Total	..	+43.3
1956 1st Quarter	..	..	..	+ 4.6

The table above shows that only in two out of five years there were deficits and these were not of an alarming size. On the other hand, the pressure of the restrictive monetary policy, after the immediate impact was over, did not appear to be very significant as indicated by the rise in the volume of bank credit in the busy seasons. Except in the year 1952-53, in all other years between 1951-52 and 1954-55, the busy season expansion of bank credit was larger than the slack season contraction which were as follows³:

TABLE 5

			Busy season	Slack season
1951-52	..	..	+ 91.7	— 84.5
1952-53	..	..	+ 78.1	—116.6
1953-54	..	..	+ 98.7	— 76.2
1954-55	..	..	+102.2	— 57.9

Since 1953-54, there was also a larger absorption of money on account of mounting development expenditure under the Plan, deficit budgets and decreasing cash balances of the Government.

³ Report on Currency & Finance, 1954-55.

The variations in money supply since 1951-52 and the factors acting on it are shown in the table below¹ :

TABLE 6
VARIATIONS IN MONEY SUPPLY

	<i>(In crores of rupees)</i>			
	1951-52	1952-53	1953-54	1954-55
1. Total money supply with the public ..	-174.92	-39.08	+29.26	+126.65
2. Central Govt.'s deposits with the Reserve Bank	+ 18.1	-44.4	-70.0	- 6.3
3. Foreign assets held by the Reserve Bank ..	-161.1	+ 0.6	+29.2	- 23.0
4. Rupee securities held by the Reserve Bank	- 19.1	-20.8	-58.5	+ 65.8
5. Scheduled bank credit	+ 45.7	-51.4	+ 6.4	+ 65.7

It was remarkable that all these inflationary forces did not actually induce any proportionate rise in prices over the First Plan period. This can be explained by the decline in food prices consequent on rising food production. During the First Plan period while the index of agricultural production increased by 17%, food grains production rose by about 30% and in the last year of the Plan, i.e. in 1955-56, food grains production actually exceeded the Plan target by 32 lakh tons.

Industrial production also recorded a substantial increase under the impact of the Plan. In the public sector, industrial production in general increased by 38% and the production of capital goods alone increased by 70%. In the private sector, while better utilisation of the existing productive capacity was secured in such industries as textiles, sugar, vegetable oils etc., productive capacity was expanded in a number of industries such as cement, paper, soda ash, caustic soda and bicycle. This greater industrial activity was clearly reflected in the index of industrial production which recorded a continuous rise from 103.6 in 1952 to 121.9 in 1955 or by about 17.6%. Index

¹ *Ibid.*

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numbers² of agricultural and industrial production are given below :

TABLE 7

		Index of agricultural production Base : 1949-50=100	Index of foodgrains production Base : 1949-50=100			Index of industrial production Base : 1951=100
1951-52	..	97.5	91.1	1952	..	103.6
1952-53	..	102.0	101.1	1953	..	106.6
1953-54	..	114.3	119.1	1954	..	112.9
1954-55	..	117.0	115.0	1955	..	121.9

Because of a larger agricultural and industrial output and consequent increase in economic activities, the expansion of money supply during the First Plan period was related to the genuine needs of the economy and therefore could not act as an inflationary force. Money supply increasing proportionately with the expansion of economic activity is not only defensible but necessary. Taking the variations in the size of national income as measuring the level of economic activity, it is possible to make a rough estimate of the requirement of money supply to finance the national income.

During the First Plan period, between 1950-51 and 1953-54, national income at current prices increased by about 10%. Increase in national income over these years indicated the need for an appropriate expansion of money supply. But actually money supply over these years recorded a decline of nearly 10% from Rs. 1976 crores to Rs. 1777 crores. The failure of money supply to expand appropriately with the increase in national income is clearly reflected in the rise in income-velocity by nearly 22%. In fact, except in the year 1950-51, money supply was far from being much in excess in relation to requirements ; on the contrary, it proved actually to be short of requirements by Rs. 94 crores in 1953-54. Thus, for the major part of the First Plan, i.e., between 1950-51 and 1953-54, money supply did not have any significant impact on prices.

In 1954-55, however, while national income showed a decline of 8.3%, money supply rose by 7.4%. In the next year although national income recorded a small rise of about 3%, money supply

² First and Third Five Year Plans and Five Year Plan Progress Report.

recorded a substantial increase of 14%. Against the background of either a fall or a small rise in national income, the expansion in money supply appeared rather unwarranted and its impact on prices also came to be felt since mid-June 1955. All this is illustrated in the table below.

TABLE 8

Year	National income (In crores of rupees) at current prices	Money supply (In crores of rupees)	Income velocity of money 1÷2	Requirements of money supply to finance national income with income velocity at 1952-53 level 1÷3	Excess (+) or deficit (-) of 2 in relation to 4
	(1)	(2)	(3)	(4)	(5)
1950-51 ..	9,530	1,976	4.82	1,701	+275
1951-52 ..	9,970	1,796	5.55	1,780	+ 16
1952-53 ..	9,820	1,753	5.60	1,753	0
1953-54 ..	10,480	1,777	5.89	1,871	- 94
1954-55 ..	9,610	1,910	5.03	1,716	+194
1955-56 ..	9,980	2,184	4.56	1,782	+402

Note: For arriving at the requirements of money supply, the income velocity for the year 1952-53 has been taken to be normal because by that year, the inflationary pressure had completely spent itself out and at the same time the First Five Year Plan was well under way. So, the increase in cash balances necessitated by larger economic activities might well be represented by the income velocity in that year.

DEVALUATION OF THE RUPEE

Attention has already been drawn to the impact of devaluation on the price level of this country. Devaluation of the rupee which took place in September, 1949, was a major event in the history of Indian currency in the post-war period. It is therefore necessary to make a detour at this stage and analyse whether there were any other conditions that brought about the devaluation of the rupee, quite apart from any need felt to follow the British example. The problem before the country was to acquire larger export earnings, insulating the economy at the same time from any new inflationary upsurge. It is interesting to note that while devaluation was called for as a corrective measure to wipe out the persistent balance of payments deficit, it was directly in conflict with the anti-inflationary objective of the Government. In order to understand the full impact of devaluation on the economy, it is necessary to have a brief reference to the situation that prevailed just prior to the adoption of this measure.

In the years before the World War II India enjoyed a surplus in its balance of payments with the United States and during the war the surplus continued to increase. This was, however, completely reversed at the end of the war. India's current transactions with hard currency areas showed a net deficit of Rs. 4.8 crores in 1946, Rs. 85.8 crores in 1947 and Rs. 49.6 crores in 1948¹.

There were a number of factors after the war that depressed so seriously the country's balance of payments position. As a result of partition, India lost not only her valuable export items but became heavy importer of some of them. Thus from having a monopoly of the world's export trade in jute, Indian Union almost overnight turned out to be the world's largest importer of raw jute. The same was the situation in respect of cotton. India's imports continued to increase firstly because there was a persistent food deficit and secondly because there was the need

¹ *Reserve Bank of India Bulletin*, July, 1949, Table III, p. 450.

to meet the backlog of postponed demand during the war and the requirements of capital replacement and reconstruction.

Superimposed upon these factors were the effects of inflation. Even prior to devaluation, Indian goods were systematically being priced out of dollar markets because of the prevailing high prices of Indian goods. It must be pointed out, however, that Indian exports were being diverted from hard currency areas to soft currency areas by virtue of the latter's ability to pay higher prices (in terms of rupee) owing to the prevalence of acute inflationary conditions in their own economies². Considered in the light of inflationary conditions prevailing in these countries, India's dollar problem consequent on adverse trade balance cannot, therefore, be solely attributed to the inflation prevailing within her own territory.

The deficits in the years immediately preceding devaluation did not present any serious difficulty because they were financed out of the central pool of gold and dollar reserves of the Sterling area when no limits had yet been imposed on the convertibility of Sterling. But from January, 1948, the U. K. expressed her unwillingness to bear this responsibility any longer and insisted on placing definite limits on the convertibility of Sterling. Henceforth only a part of the total dollar and hard currency deficit could be met out of releases from the Central Pool and India had to fall back upon purchases of dollars from the I.M.F. to finance her deficit.

On the eve of devaluation, together with the need to curb inflation, there was the urgency for the country to earn valuable foreign exchange to satisfy the demand of her most-needed imports from hard currency areas. When devaluation was adopted in September 1949, many writers were critical about its adequacy as a corrective measure of the chronic deficit in the balance of payments. On the contrary, it was actually feared that this measure would create in the economy a fresh inflationary upsurge. The price-movements in the post-devaluation period would, however, suggest that the extent of price rise was not so much as was apprehended. This is largely to be explained by the various anti-inflationary measures taken by the Government simultaneously with devaluation. The Government took such

² *Reserve Bank of India Bulletin*, July, 1949, p. 452.

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measures as imposition or enhancement of export duties, intensification of the savings campaign, a vigorous drive to realise evaded taxes and lowering of the retail prices of food-grains, yarn and cloth.

In the nine months following devaluation, that is, by June, 1950, the index of prices for food articles declined by nearly 2%, while the index for semi-manufactures rose by 1.4% and that for manufactured articles fell by 0.3%. On the other hand, the index for raw materials rose by 6.6%, that for the miscellaneous group by about 28%, the general index by about 2% and the cost of living index for Bombay also by 2%. An idea of the movements in price indices since August, 1949, one month before devaluation can be obtained from the following table³.

TABLE 1

	August, 1949	June, 1950	Percentage increase or decrease
Food articles	410.6	402.8	- 1.9
Industrial raw materials ..	460.5	490.7	+ 6.6
Semi-manufactures	330.8	335.5	+ 1.4
Manufactured goods	348.6	347.6	- 0.3
Miscellaneous	541.6	692.0	+27.8
All commodities	389.0	395.6	+ 1.7

It is interesting to note that during the same period the general index of wholesale prices recorded a rise of 11% in the U. K., 6% in Canada, nearly 17% in Australia and 3% in France⁴. Thus, by comparison, India was able to maintain her prices more or less stable in the months immediately following devaluation.

One of the important sources from which the effect of devaluation could be felt upon prices was the amount of balance of payments surplus and consequent increase in the acquisition of foreign assets by the Reserve Bank of India. The table below shows a close correspondence between balance of payments, amount of foreign assets and notes in circulation. During July-December, 1949, India earned a net surplus of Rs. 10.1 crores on current account with the Sterling area and a surplus of Rs. 6.0 crores with the hard currency area⁵. These surpluses led to an

³ *Report on Currency & Finance, 1950-51, Statement 15(A)*, p. 150.

⁴ *Report on Currency & Finance, 1950-51, Statement I*, p. 129.

⁵ *Report on Currency & Finance, 1950-51, Statement 74*, p. 226.

expansion in the foreign assets held by the Reserve Bank and consequent larger absorption of notes, as shown in the table below.

TABLE 2

	<i>Slack Season</i> 13th May 1949 to 28th Oct. 1949	<i>Busy Season</i> 28th Oct. 1949 to 12th May, 1950
1. Notes in circulation	-124.86	+122.06
2. Foreign assets held by the Reserve Bank	- 88.40	+ 61.51
3. Wholesale prices	+ 4. 6	- 0. 3

Thus in spite of such a large absorption of currency during the busy season of 1949-50 induced partly by the rise in the foreign assets of the Reserve Bank, wholesale prices declined by 0.3%. This shows that the various measures taken by the Government against inflation proved effective. Thus, it is clear that judged by results, devaluation did not create any serious difficulty on the price front.

So far as balance of payments was concerned, many writers believed that the main explanation of the chronic disequilibrium in the balance of payments for many countries in the post-war years was to be found in the far-reaching structural changes that had taken place. The dislocation of production by war, the huge capital needs for reconstruction and development together with the backlog of consumer demand, the dependence of the rest of the world upon imports of agricultural products from the Western Hemisphere, the increasing technical superiority of the United States precluding the emergence of foreign competition with American products, the development of synthetic products and substitutes—all these constituted important structural factors which proved to be sources of chronic disequilibrium. Besides, there was also a revolutionary change in the debtor-creditor relationships owing to the loss of pre-war sources of invisible income for a large number of European countries. Some of these countries in the past used to settle their deficits with the U. S. out of their invisible income and out of surpluses with the Eastern countries⁶.

When the disequilibrium is of a structural character, a mere devaluation of the currency can never be a decisive solution. For

⁶ Dr. S. K. Baru, *Devaluation and Dollar Problem*, p. 24.

a country faced with the problem of structural disequilibrium, very great changes in the structure of production and pattern of consumption must precede the restoration of equilibrium—changes that involve the setting up of new industries, the expansion or modernisation of the old ones, encouraging some of the existing industries while scrapping up of others. In the case of India the structural problems were the inadequacy of incentives for risk capital, lack of capital itself, price and wage rigidities preventing mobility of resources, etc., although the immediate cause of the balance of payments difficulties was the impact of the War and the Partition. In such circumstances, as Triffin has observed, balance of payments difficulties continue until reconstruction policies begin to bear fruits in the shape of increased production and such selective controls as import restrictions, exchange control and fiscal measures and not a general control measure like currency depreciation, are advocated. A general control measure like devaluation in such cases usually brings in its wake serious hardships and lowers the rate of exchange more than is ultimately useful⁷. Devaluation brings about a changed pattern in the internal and external price-cost relationships and so long as the structural adjustments are not made, the devaluing country cannot in fact reap the full benefits of devaluation by responding fully to these changes. It was also argued that India's exports to the dollar areas consisted mainly of raw materials and agricultural products the demand for which was pretty inelastic. Hence, there was very little possibility of any sizable expansion of their exports in response to the reduction in their prices in terms of foreign currency.

The expenditure on imports in terms of dollars could of course be reduced so long as the physical volume of the imports declined as a result of devaluation. But the question was whether imports could at all be reduced. Most of India's imports from dollar areas were composed of essential goods and as such the quantity could hardly be slashed to any great extent. India's own elasticity of supply of Indian exports was also another important consideration. Where the domestic supply position rules out the possibility of larger quantities being made available

⁷ Triffin's Article, "Exchange Control and Equilibrium" in *Foreign Economic Policy for the United States*.

for export, the stimulus provided by devaluation is of little benefit. Oil seeds, for example, could not reap the benefit of devaluation since the major part of the total supply was absorbed in local consumption.

The ultimate effect of devaluation depends upon the magnitude of the decline of the foreign value of exports compared with the decline in the value of imports. An important condition for the improvement in the balance of payments is that the value of imports must fall more than the value of exports⁸. So far as India was concerned, if she could reduce the foreign currency prices of jute manufactures and maintain those of other exports, and at the same time could substantially reduce her imports, devaluation might benefit the country. But it was extremely doubtful if India could reduce the foreign currency prices of jute manufactures owing to Pakistan's decision not to devalue and reduce her imports owing to the inelasticity of her demand for imports from dollar areas.

Coming to concrete facts, one has to examine how the actual trend in the post-devaluation period of foreign trade conformed to expectations. A glance at the figures tabulated below would show that devaluation was followed by a period in which the adverse balance of trade gave place to a considerable favourable balance :

TABLE 3
(In lakhs of rupees)

	Land-borne trade with Pakistan included	Monthly averages (Rupees lakhs)		
		Imports	Exports	Balance
	1948-49	50.27	37.76	-12.51
April-September	1949	57.85	35.62	-22.23
October-December	1949	47.22	48.59	+ 1.37
January-March	1950	32.73	46.68	+13.95
April-June	1950	45.70	22.33	-12.37

In the six months following devaluation (Oct. 1949—March 1950) imports showed a substantial fall as compared with the position in the preceding half-year and simultaneously there was almost an equal increase in exports. It should be pointed out here that the reduction in imports, although due partly to devaluation which raised the prices of imported goods, reflects

⁸ Lloyd Metzler's article in *A Survey of Contemporary Economics*, p. 226.

mainly the tightening of quantitative restrictions on imports. An important, though frequently overlooked, cause of the favourable trade balance was, therefore, not the devaluation itself but the change in import policy, which in effect, synchronised with it. The main interest here is, however, the export trade and we have to examine how far the expansion in exports could be linked directly or indirectly to devaluation.

One fact which should be constantly kept in view when examining the trends after devaluation is that in Sept. 1949 when the rupee was devalued by 30.5%, twelve other countries devalued their currencies to the same extent and seven others to a smaller extent.

What may be regarded as the effective depreciation of the rupee was, therefore, much less than 30.5%, depending upon the countries from which India normally imports or to which she normally exports goods. If the values of imports from different countries in the first half of 1949 are considered and in proportion to these values weights are given to the extent to which the rupee depreciated in terms of the currency of each exporting country, the average devaluation would come to 11.2% ; conversely, the average appreciation of foreign currencies in terms of the rupee would be 12.6%. On the basis of the values of India's exports in the first half of 1949 the average depreciation of the rupee and the average appreciation of foreign currencies worked out to 12.2% and 14% respectively.*

In all the devaluing countries, there had been an increase in both export and import prices after Sept. 1949. But generally import prices had increased by a larger margin than export prices. This was to be explained by the inelasticity of the demand for goods imported from America and other non-devaluing countries. It is well known that by virtue of her monopolistic position in several of her export commodities American export prices did not fall to any significant extent with the result that in the importing countries prices of American goods recorded a sharp increase. The export prices of the devaluing countries on the other hand were subject to greater competitive pressure. An

* These calculations are made on the assumption that except the impact of devaluation, there was no change in any other factor affecting India's foreign trade.

increased quantum of goods could be shipped to hard currency countries only by allowing a reduction in the dollar prices, and hence the rise in the export prices of the devaluing countries was restrained. This trend was also visible in India's case. With August 1949 equal to 100, the movement of import and export prices had been as follows :

TABLE 4
MOVEMENT OF IMPORT AND EXPORT PRICES*

				Import prices	Export prices
August	1949	..	..	100	100
September	"	..	..	105	104
October	"	..	..	117	105
November	"	..	..	113	108
December	"	..	..	124	107
January	1950	..	..	120	106

Comparing the price trends with the change in the foreign value of the rupee it will be seen that import prices had increased much beyond the average appreciation of the foreign currencies in terms of the rupee, i.e. 12.6%. This indicates that, among India's suppliers, the devaluing countries allowed at least some increase in their prices and the non-devaluing countries effected at best a small reduction in their prices. The main interest is, however, the effects of devaluation on India's export trade. From the above table it is clear that export prices had been steady at about 7% above the pre-devaluation level. But the weighted average of the devaluation of the rupee in relation to India's export markets was 12.2%. Looking at the position from our customers' point of view, even an increase of 14% in the rupee prices of the commodities would have meant that the customers paid for the commodities the same prices in their currency which they used to pay before devaluation. The difference between this figure and the increase in the export prices can be taken as a broad measure of the price advantage that the average Indian export consignment obtained from devaluation.

Another indication of the change in India's competitive position in world trade is provided by the movement of the general wholesale price-index number. Since Aug. 1949 up to June

* *Tata Quarterly*, Jan-March, 1950, V. 5, No. 2.

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1950 the general price index rose by 1.7% while in the more important of the other devaluing countries the increase was much more pronounced, as we have already stated in a previous paragraph.

This general analysis of prices may be supplemented by an examination of the flow of exports to hard currency countries and soft currency countries respectively. India's exports excluding re-exports to the two groups of countries before and after devaluation were as follows :

TABLE 5

Monthly averages 1948-49		Hard Currency countries (Rs. Lakhs)	Soft Currency countries, excluding Pakistan (Rs. Lakhs)	Total (Rs. Lakhs)
	1948-49	..	2081	3080
April-September	1949	..	2428	3108
October-December	1949	..	2794	4271
January-March	1950	..	2982	4479
April	1950	..	2059	2931
May	1950	..	2447	3341

In the six months after devaluation, exports to hard currency countries doubled in comparison with those in the preceding half-year. Exports to soft currency countries, however, increased by only a quarter. Subsequently, exports to all countries declined sharply, the fall being relatively greater in exports to hard currency areas. This may appear to be a rather curious phenomenon ; for, *prima facie*, it could be expected that the hard currency countries being in the main those which had not devalued, India's exports to them would thrive under the stimulus of devaluation for a longer period than exports to soft currency countries. The explanation could be found in the dwindling availability of the right kind of commodities which could be sent to the hard currency markets.

The foregoing analysis of the export trade shows that the lowering of the exchange value of the rupee did play a significant part in increasing the value of exports. In the case of the dollar area, there was a direct advantage and this was used. In the case of the soft currency area there was an indirect price advantage in respect of cotton textiles, tobacco and oil seeds.

Since India was able to keep her prices relatively stable after devaluation and since the resultant improvement in the competitive position was turned to good account by stimulating an outflow of goods even at the cost of allowing the domestic stocks of commodities like raw jute, jute manufactures, raw cotton etc. to run down to very low levels, it seems fair to conclude that on the whole the brief opportunity provided by devaluation was reasonably used. It must not be forgotten that in the nature of the case the policy pursued was a short-range policy and the fall in exports to both the hard and soft currency countries in April and May 1950 definitely suggested that the initial advantage resulting from devaluation had played itself out. The point had therefore been reached when attention had once again to be focussed on the two fundamental problems of (a) prices and (b) availability of exportable surplus.

The foregoing study shows that devaluation gave utmost a breathing space in which India could try to put the things in order and that apparently it spent its force by March 1950, because in the next three months exports declined again to the level prevailing prior to October, 1949. Fundamentally, the problem was one of structural disequilibrium and no lasting solution of the balance of payments problem could be reached without making room for an altered pattern of production and consumption. Indeed, the arguments advanced against devaluation on the basis of its possible repercussions were very forceful and this cogency of the arguments was also admitted by the Government when the Finance Minister just after devaluation observed in Parliament that he had "to act not on conviction born of logic necessarily, but, so to speak, by the compulsion of events¹⁰."

The "compulsion of events" was that when Britain devalued the pound sterling and other members of the sterling area followed suit, adherence to the old parity of the rupee by India might have seriously undermined her competitive position not only in hard currency markets but in the sterling area too. India's devaluation was described as a purely defensive measure. The Government seems to have banked upon the possibilities of expansion of exports to the sterling and other soft currency areas.

¹⁰ "Parliamentary Debates", published in the *Statesman*, Oct. 6, 1949.

But in view of the inflationary conditions prevailing in most of these areas, there was hardly any likelihood of Indian goods losing these markets, even if there was no devaluation. Moreover, much of the exchange advantage was offset by Pakistan's decision not to devalue. The maintenance of the old parity by Pakistan increased the price of imported raw jute in terms of the Indian rupee. This higher cost of the raw material was reflected in the price of jute manufactures. According to one estimate raw jute prices form about 70% of the cost of jute manufactures¹¹. In these circumstances, Indian jute manufacturers could not take full advantage of devaluation in the shape of any spectacular increase in exports. All these considerations will set one thinking if there was any alternative measure to devaluation.

In this connection the measures adopted in one of India's neighbour countries, namely the Philippines, would be of particular interest. The nature of the balance of payments problem in the Philippines was similar to that faced by India before devaluation. Hence, a study of the Philippine payments problem and the steps taken to cope with it may throw much light on the alternative measures that might have been adopted in India. Owing to the war-time destruction of productive capacity and economic dislocation, production in the Philippines as in India, was very low during the early post-war years. This, coupled with the need for meeting domestic consumption, reduced considerably the availability of exports. At the same time, the country's need for imports increased tremendously to supplement the meagre production of foodstuffs, meeting the pent-up demand, replenishing the depleted inventories and rebuilding the country's productive capacity¹². There was also an acute inflation due to large United States Government disbursements, Philippine Government expenditure and private investment. A substantial portion of the increased private investment was diverted to commerce and real estate¹³. Production failed to expand rapidly and did not keep pace with high consumption, a major part of which was met by excessive imports, including non-essentials and luxury goods. The

¹¹ Press note issued by the I.J.M.A. in the *Statesman*, Sept. 21, 1949.

¹² *Economic Bulletin for Asia and the Far East*, Vol. V., No. 3, Nov. 1954, p. 19.

¹³ *Report to the President of the United States by the Economic Survey Mission to the Philippines*, Washington D.C., 9th Oct., 1950, p. 2.

inflation and increase in prices of domestic goods tended to worsen the competitive position of the Philippine exports. The balance of payments difficulties in 1949 resulted in a large reduction in foreign exchange reserves.

To tackle this problem, import controls, first put into effect in January, 1949, were relatively moderate and affected mainly luxury items. When the balance of payments situation became critical from December 1, 1949 onwards, controls were extended to cover all imports, which were subject to licensing by the Import Control Board. Exchange control was imposed on December 9, 1949. All transactions in gold and foreign exchange except those for merchandise imports covered by import licences, were subject to licensing by the Central Bank. In order to avoid any unwarranted rise in the prices of imports because of these restrictions, price control was adopted in mid-1950.

The import controls had an immediate effect in reducing imports. The total value of imports in 1950 declined by about 40% from that in 1949 and the trade deficit was reduced from P676 million to P45 million, which was only less than 10% of the total value of exports¹⁴. But although import controls produced an immediate effect in reducing imports, they were not a sufficient remedy by themselves. A large portion of the expenditure that had been cut off from imports were diverted to domestic goods which tended to raise their prices and render price control ineffective. The reduction in the supply of imported goods without a corresponding decrease of expenditure would also raise the prices of imported goods, bringing wind-fall profits to the importer. Thus, import controls, unaccompanied by an adequate elimination of excessive effective demand, were unlikely to be successfully carried out.

Devaluation might be a possible solution but it was ruled out as economically undesirable. Undoubtedly, it would be effective in reducing imports. But it would raise local prices of all imports—whether essential or non-essential—to the same extent, and would not have a selective effect. Higher prices for major wage goods such as imported clothing materials, were bound to produce an unfavourable effect on the poor class.

¹⁴ *Economic Bulletin for Asia and the Far East*, Vol. V. No. 3, Nov. 1954, p. 21.



On the export side, it would probably have only a negligible effect in increasing production of export goods. With the exception of coconut oil, the difficulties of increasing production in the Philippines during the period under review were of a technical, rather than price, character. The production of export crop was very profitable as the wage rates in Agriculture rose less than prices. The increase in profitability of exports might reduce some home consumption and increase export availability. Such reduction could not, however, be quantitatively significant because home consumption of export goods is relatively small in the country. Moreover, as time would pass on, the rise in the local prices of export goods would be transmitted to those of agricultural commodities for domestic consumption, as the domestic agricultural products compete with export goods for labour. Thus on the export side, devaluation would bring about only a slight increase in export quantity and a large increase in export profits without appreciable increase in foreign exchange earnings. Such increase in profits coupled with unselected rise in all import prices, would produce ill effects on the distribution of income¹⁵.

In view of these considerations, the Philippine Government rejected devaluation and chose to levy an exchange tax being 17% of the value in Pesos of foreign exchange sold by the Central Bank and its agencies effective from 28th March, 1951. The rising world prices for the Philippine exports after the outbreak of the Korean War and the continuous application of stringent exchange and trade controls resulted in a substantial improvement in the balance of payments position from mid-1950 and the exchange tax adopted by the Philippine Congress was somewhat lower than had been recommended by the Economic Survey Mission sent by the U.S. President¹⁶.

The most important effect of the exchange tax was to siphon off the importers' wind-fall profits to the Government, eliminate the budget deficits and weaken the inflationary pressure, thus helping to remove the balance of payments difficulties. The imposition of the tax resulted in a considerable increase in

¹⁵ E. M. Bernstein, "The Bell Report and the Philippine Payments Problem", Nov. 3, 1950, an unpublished paper quoted by the *Economic Bulletin for Asia and the Far East*, Vol. 5, No. 3, Nov. 1954, p. 22.

¹⁶ *I.M.F. Annual Report*, 1951, p. 55.

Government revenue. The budget balance turned from a large deficit of P153 million in 1949-50 to a large surplus of P117 million in 1951-52. The exchange tax revenue, estimated at P150 million, accounted for about one-fourth of total tax revenue in 1951-52. The revenue thus raised might be used at least partly for financing economic development.

As in the Philippines, so in India, there were many obstacles to the expansion of exports to the dollar areas. In the case of India, these obstacles related to inflation within the country, the development of synthetic products and substitutes abroad, the shortfall in supply caused by Partition, increased internal demand due to the growth of home industries etc. If exports to dollar areas could not be appreciably expanded, the remedy for the balance of payments deficits should have been sought in the direction of import cuts rather than in export increases. As the Philippines had rightly decided, devaluation has no selective effect. The peculiar circumstances in India before devaluation were that the country could ill afford to forego the imports of food, machinery and other capital equipments while at the same time it could not allow the deficits in its foreign exchange budget to continue year after year. From this point of view, such selective controls as import restrictions, quotas, tariffs, exchange control would have been of far greater advantage to the country; for these would have stopped the import of non-essentials and luxury goods without hindering at the same time the import of essential commodities.

Chapter IV

ADVENT OF GROWTH INFLATION

The downtrend in wholesale prices that started since mid-April 1954 persisted till early June, 1955 when the general index declined to 340.6—the lowest since March 1948. From the third week of June, however, this downtrend was reversed and the uptrend that set in then continued throughout the year. This is illustrated in the following table :

TABLE 1
INDEX NUMBERS OF WHOLESALE PRICES¹

(Base : 1939=100)

	Food articles	Industrial raw materials	Manu- factures	General index
March 1954 ..	371.4	462.5	373.9	394.0
March 1955 ..	297.0	412.7	374.3	353.8
June 4, 1955 ..	276.7	386.2	371.0	340.6
June 18, 1955 ..	284.9	393.1	369.3	343.9
Dec. 31, 1955 ..	327.4	454.7	373.6	373.4
March 31, 1956 ..	358.8	477.9	373.6	390.3

As we shall presently see, this rise in prices persisted throughout the Second Plan period too so that the price rise during the years of the Second Plan may be regarded as the continuance of the uptrend started since June, 1955. Behind this continued rise in prices from June 1955 there were several factors at work related to the process of growth. Firstly, of the total public sector outlay of Rs. 1960 crores for the entire First Plan, Rs. 613.91 crores was spent in 1955-56 alone—the highest amount of investment expenditure made in any single year within the First Plan period. Year-wise distribution of the total outlay under the First Plan, given below, will show that investment expenditures in the years 1954-55 and 1955-56 were substantially higher over the levels in the previous three years.

¹ Report on Currency & Finance.

TABLE 2

OUTLAY IN THE FIRST PLAN—YEAR-WISE DISTRIBUTION²

(In crores)

1951-52	1952-53	1953-54	1954-55	1955-56	Total
259.60	267.53	343.04	475.92	613.91	1960

Secondly, deficit financing in 1955-56 was also the highest at Rs. 157 crores as compared to only Rs. 2 crores in 1951-52, Rs. 44 crores in 1952-53, Rs. 36 crores in 1953-54 and Rs. 94 crores in 1954-55³.

In the third place, deficit financing of the order of Rs. 157 crores had, in its turn again, a significant influence on the rate of expansion of money supply which was also the highest in 1955-56. It is well known that in so far as a part of the additional money created by deficit financing comes to banks in the form of deposits, the power of the banking system as a whole to create more credit is enhanced and with an extension of credit money supply becomes augmented.

Variations in money supply during the years 1950-51 to 1955-56 together with the factors influencing the growth of money supply are given in the table below :

The table shows that from 1954-55, a significant change in the seasonal trends of money supply and bank credit was noticeable. The contraction during the usual slack period (May to October roughly) was becoming less pronounced than before, while the expansion during the busy season (November to April roughly) was growing in magnitude. Thus, it may be pointed out that in the 1955 slack season, i.e., from May 7 to October 28, money supply declined by only Rs. 3 crores as compared to Rs. 77 crores in the 1954 slack season and Rs. 128 crores in the 1953 slack season. Similarly, bank credit to the private sector during the same period showed a relatively smaller decline of Rs. 30 crores as compared with a decline of Rs. 63 crores in the 1954 slack season and of Rs. 80 crores in the 1953 slack season. On the other hand, the busy season expansion of money supply as a whole and bank credit in particular were larger in the two years 1953-54 and 1954-55 than the contraction in the slack

² *Third Five Year Plan*, p. 738.

³ *Ibid.*, p. 733.

TABLE 3

VARIATION IN MONEY SUPPLY

(In crores of rupees)

	1950-51		1951-52		1952-53		1953-54		1954-55		1955-56	
	Stock	Bury	Stock	Bury	Stock	Bury	Stock	Bury	Stock	Bury	Stock	Bury
1. Currency with the public ..	-109.7	+220.0	-193.4	+53.3	-104.3	+103.1	-124.6	+155.0	-96.8	+190.0	-32.1	+237.2
2. Deposit money with the public ..	+19.1	+16.9	-20.7	-28.8	-22.4	-18.4	-3.0	+16.5	+19.4	+32.1	+28.9	+26.4
3. Money supply with the public ..	-90.6	+236.9	-214.1	+24.5	-126.7	+84.7	-127.6	+171.5	+77.4	+222.1	-3.2	+263.6
Factors affecting money supply ..												
(a) Central Govt. deposits with Reserve Bank ..	+30.5	-31.0	+58.6	-46.6	-7.0	-39.6	+33.3	-52.1	+56.4	-91.1	-0.8	+16.0
(b) Other Govts. deposits with Reserve Bank ..	-2.2	+9.9	-6.9	-12.1	+10.5	-2.2	+5.7	-0.3	-6.6	+8.7	+7.0	-23.6
(c) Foreign assets held by Reserve Bank ..	-43.4	+74.0	-84.9	-81.2	-22.3	+26.0	-19.9	+54.4	-22.9	-14.8	-3.4	+5.6
(d) Rupee Securities held by Reserve Bank ..	+1.5	+82.6	-27.5	-35.4	+8.3	-13.2	-23.4	-19.9	+25.3	+62.0	+18.7	+148.5
(e) Loans & advances to Govts. by Reserve Bank ..	-4.1	+6.1	-1.9	-3.8	+2.2	+0.8	-4.2	+0.1	+0.1	-0.1	-0.8	+2.6

TABLE 3—Continued

VARIATION IN MONEY SUPPLY

(In crores of rupees)

	1950-51		1951-52		1952-53		1953-54		1954-55		1955-56	
	Stack	Busy	Stack	Busy	Stack	Busy	Stack	Busy	Stack	Busy	Stack	Busy
(f) Other loans & advances by Reserve Bank ..	—	6.1 + 18.4	—	16.2 + 44.8	—	42.2 + 24.8	—	22.3 — 52.5	—	45.4 + 21.9	—	20.9 + 68.5
(g) Bills purchased & discounted by Reserve Bank ..	—	1.3 + 2.1	+ 3.3 + 5.7	— 10.4 + 10.8	—	11.4 + 9.3	—	3.0 + 4.0	—	4.9 + 3.0		
(h) Cash on hand & balances with Reserve Bank of banks ..	+ 26.3	— 23.7	+ 24.8 — 32.6	+ 18.4 — 26.5	+ 10.1 — 8.7	+ 20.4 — 11.9	+ 12.1 — 7.8					
(i) Advances & bills purchased & discounted in India by banks ..	— 64.3	+ 173.1	— 82.6 + 92.7	— 120.3 + 80.9	— 79.8 + 107.8	— 63.4 + 102.6	— 30.1 + 183.0					
(j) Investments in Govt. securities by banks ..	+ 31.8	— 60.1	+ 9.0 — 19.2	+ 19.0 — 9.5	+ 34.4 — 9.9	+ 24.3 — 0.9	+ 53.2 — 37.4					
(k) Time liabilities of banks ..	+ 2.1	+ 15.4	— 3.6 — 7.9	+ 29.2 + 16.2	+ 8.3 + 1.9	+ 23.7 + 32.2	+ 40.3 + 12.7					

Source: Report on Currency & Finance, 1955-56, p. 136.

periods of 1953 and 1954. Since, in the busy season of 1953-54, money supply expanded by Rs. 171 crores and in the slack season of 1954 declined by Rs. 77 crores, the volume of money supply at the commencement of the next busy season of 1954-55 was Rs. 94 crores higher than at the start of the previous busy season. If the busy season expansion in money supply becomes substantially larger than the slack season contraction every year, each succeeding busy season starts with a larger money and credit base. The net effect is that the disinflationary effect of the slack season decline becomes more than offset by the inflationary effect of the busy season expansion. Thus the nominal decline of money supply by Rs. 3 crores and contraction of bank credit by only Rs. 30 crores during the slack period of 1955 lasting from May to October did not have any disinflationary effect on prices which started rising from June 1955. During the same period, balance of payments deficit was not also large enough to force any substantial contraction of money supply. External payments position, as indicated roughly by the foreign assets held by the Reserve Bank showed a small deficit of Rs. 3 crores during the period May to October, 1955. The volume of money supply at the start of 1955-56 busy season also was Rs. 219 crores higher than at the commencement of the previous busy season, the total expansion of money supply over the year 1955-56 as a whole being Rs. 264 crores. This expansion was more than twice that of 1954-55 and the largest rise in any year in the post-war period. The following table shows the volume and variations in money supply in each year between 1951-52 and 1955-56⁴ :

TABLE 4

			Money supply with the public (In crores of rupees)	Variations in money supply with the public (In crores of rupees)
1951-52	..	..	1,803.79	-174.92
1952-53	..	..	1,764.71	- 39.08
1953-54	..	..	1,793.97	+ 29.26
1954-55	..	..	1,920.63	+126.65
1955-56	..	..	2,184.31	+263.68

⁴ Report on Currency & Finance, 1955-56.

The table on pages 56-57 showing the seasonal trends in money supply reveals that the 1955-56 busy season expansion of Rs. 264 crores exceeded the previous year's seasonal expansion by Rs. 42 crores and even the post-Korean expansion in the 1950-51 season by Rs. 27 crores. This monetary expansion was induced mainly by budgetary deficit* and bank credit to the private sector. The former was slightly higher at Rs. 159 crores as compared to Rs. 144 crores in the 1954-55 busy season. The decline in Government security holdings of banks by Rs. 37 crores had of course a contractionist effect; but the rise in bank credit to the private sector was larger at Rs. 183 crores as compared to Rs. 103 crores in 1954-55. On the other hand, the rise in time liabilities of banks in the 1955-56 busy season was Rs. 19 crores smaller at Rs. 13 crores. If this relatively smaller rise in time liabilities is considered, the increase in net indebtedness of the private sector to the banking system in the 1955-56 busy season amounted to Rs. 170 crores as against Rs. 70 crores only in the previous busy season. The balance of payments surplus of Rs. 5 crores also produced a small expansionist effect on money supply.

In the sphere of national income also, the rising trend witnessed since 1951-52 was maintained in 1955-56, though the increase in 1955-56 was a little smaller than in 1954-55. The trends in national income estimated at 1948-49 prices are shown below⁵:

(In crores of rupees)

1951-52	1952-53	1953-54	1954-55	1955-56
9,100	9,460	10,030	10,280	10,480

These estimates show that over the five-year period from 1951-52 to 1955-56, national income expressed at 1948-49 prices rose by about 15% representing an average annual rate of increase of 3%.

* For purposes of analysis of money supply variation, budgetary deficit is measured by the extension of Reserve Bank Credit to Govt. (mainly indicated by the purchase of Govt. securities by the Bank) after making adjustments for net changes in Govt. cash balances with the Reserve Bank.

⁵ *Estimates of National Income*, Central Statistical Organisation, Govt. of India.

Thus in the year 1955-56 within the First Plan period, the Indian economy experienced the largest absorption of money supply, witnessed the largest amount of investment outlay in the public sector and was administered the heaviest dose of deficit finance. All these factors combined together to swell the aggregate effective demand in the economy.

Against this rising demand, the supply of many articles, particularly of the food group, was not satisfactory. In fact, the rise in prices from June 1955 was the result of a somewhat larger demand impinging on a somewhat smaller supply. There were lower output of cereals during 1954-55, rising exports of some industrial raw materials during 1955-56 and apprehensions of lower output in the 1955-56 season due to floods or drought in parts of the country. The fall in the production of food grains during 1954-55 from the previous year's level was caused mainly by a decline in the output of cereals from 58.3 million tons to 55.3 million tons. This was, in turn, due mainly to a decline in rice production from 27.8 million tons to 24.2 million tons. Except wheat and jowar, other cereals also taken together recorded a decline from 14.7 million tons to 13.5 million tons. These declines could not be offset by the nominal rise of wheat and jowar by 0.6 million and 1.1 million tons respectively.

Industrial production was of course satisfactory, the index of industrial production (base : 1946=100) touching a new all time peak in December 1954. This trend continued in 1955 also, the aggregate industrial production in that year showing a rise of 8 per cent. The rise in 1955 was quite substantial in sugar, paper, jute manufactures, general engineering, automobiles and rubber. This steady rise in production, however, could not bring about a fall in prices. It may be observed here that during the rising phase of the general price index from early June 1955 to end-March 1956, while the "food articles" group and the "industrial raw materials" group showed considerable rises, the price index of the "manufactures" group remained steady without showing any decline to offset the rises in the former two groups. This explains the rise in general prices despite a steady rise in industrial production. The causes of the price rise since June 1955 may now be summed up as follows :

Increasing consumption demand consequent on higher investment and incomes in the economy set against the shortfalls in food-grains production and the scarcity of some commodities in the domestic market due to rise in their exports brought about the rise in prices. There might have been also another factor. As the formulation of the Second Plan was progressing, there was increasing awareness within the country that the rate of investment would be substantially higher and that there would also be a much larger dose of deficit finance. In this situation, speculative demand to a certain degree might have been superimposed on the already rising consumption demand. Thus, the rise in prices since June 1955 was clearly a growth-induced inflation.

With the end of the First Plan in March 1956 began the Second Plan in April of the same year. While the First Plan, through its emphasis on agriculture, irrigation, power and transport, created the base for more rapid economic and industrial advance in the future, the Second Plan carried the basic policies under the First Plan a step further by aiming at larger investment, production and employment. It laid also special emphasis on the development of basic and heavy industries as a means of speeding up the development of the economy over the next 15 or 20 years. Details of outlay and investment of the two Plans are given below :

TABLE 5

OUTLAY AND INVESTMENT IN FIRST AND SECOND PLANS AT CURRENT PRICES^a

(In crores of rupees)

		First Plan 1951-56	Second Plan 1956-61	Total
Public Sector Outlay ..	..	1,960	4,600	6,560
Public Sector investment ..	..	1,560	3,650	5,210
Private Sector investment ..	..	1,800	3,100	4,900
Total investment ..	..	3,360	6,750	10,110

^a *Third Five Year Plan*, p. 32.

TABLE 6
DISTRIBUTION OF OUTLAY¹

(In crores of rupees)

	First Plan		Second Plan	
	Expendi- ture	Per- centage	Expendi- ture	Per- centage
Agriculture and Community development	291	15	530	11
Irrigation	310	16	420	9
Power	260	13	445	10
Village & Small Industries ..	43	2	175	4
Industries & minerals ..	74	4	900	20
Transport and Communications ..	523	27	1300	28
Social Services & miscellaneous ..	459	23	830	18
Total ..	1960	100	4600	100

The tables above will show that the Second Plan was significantly different from the First both in the scale and in the pattern of investment. The total of investments in industry, transport and power by the public sector was Rs. 2,650 crores as compared to Rs. 820 crores in the First Plan. Private investment in these fields also was larger at Rs. 1,025 crores as compared to Rs. 310 crores in the First Plan period². Naturally, developmental tasks of this magnitude involved a greater strain on the economy. While larger investment expenditure in general created a larger money income in the economy, the relatively bigger share for basic and key industries made for a comparatively lower supply elasticity of real output in the short period³. In an under-developed economy characterised by a high average and marginal propensity to consume, rising money income means also rising consumption demand. Besides consumer demand, the process of growth itself generates higher demand for various intermediate articles. Thus it may be pointed out that the programme of agricultural development outlined in the Plans necessarily raised the demand for fertilisers. The expansion of bicycles and textile industries raised the demand for more steel and chemicals.

¹ *Third Five Year Plan*, p. 33.

² *Ibid.*, p. 92.

³ The gestation period of a project, particularly in the case of heavy engineering industries is generally longer than expected.

Under these circumstances, unless output increases proportionately to the rising pressure of demand, the latter tends to produce an inflationary impact on prices. Given the investment expenditure and the resultant increase in national income, the inflationary pressure may be eliminated either by taxing away the excess purchasing power or by inducing the people to make an increase in voluntary savings. Taxation as a proportion of national income rose from about 7.5% at the beginning to only about 8.9% by the end of the Second Plan although additional taxation, as an absolute amount (Rs. 1052 crores) far exceeded the initial target⁹. Small savings also over the five-year period were about Rs. 100 crores less than envisaged earlier. Details of the financial resources of the Second Plan, given in the table below, will show that to finance the total public sector outlay of Rs. 4600 crores, deficit financing to the extent of Rs. 948 crores had to be resorted to over and above the external assistance of Rs. 1090 crores.

TABLE 7
FINANCIAL RESOURCES¹⁰
(In crores of rupees)

	Latest estimates
1. Balance from current revenues (excluding additional taxation)	-50
2. Contribution of railways	150
3. Loans from the public (net)	780
4. Small Savings (net)	400
5. Provident Funds (net)	170
6. Steel equalisation fund (net)	38
7. Balance of miscellaneous capital receipts over non-plan disbursement	22
8. Total of 1 to 7	1510
9. Additional taxation including measures to increase surpluses of public enterprises	1052
10. External assistance	1090
11. Deficit financing	948
TOTAL	4600

This large investment expenditure in the Plan induced the growth of national income, employment and wages which, in their turn, created a rising pressure of demand. Population growth was also an important factor contributing to the pressure of demand. According to the estimate made by the Planning Commission, the

⁹ *Third Five Year Plan*, p. 102.

¹⁰ *Third Five Year Plan*, p. 95.

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growth of national income at 1960-61 prices over the period 1955-56 to 1960-61 was as follows¹¹ :

TABLE 8

(In crores of rupees)

	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61
National income at 1960-61 prices ..	12,130	12,710	12,590	13,510	13,680	14,500

During the same period, the index of employment also in the organised sector rose from 104.0 in 1955-56 to 121.0 in 1960-61 or by 16.3% and the index of wages by 12.9% from 121.3 in 1955-56 to 137.0 in 1960-61 :

TABLE 9

	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61
Index of employment ¹² (organised sectors base : 1950-51=100) ..	104.0	111.2	115.9	114.9	119.0	121.0

Index of wages ¹³ (base: 1950-51=100) ..	121.3	125.0	127.6	132.6	135.0	137.0
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Population also increased during the period by 10% from 397 millions in 1955-56 to 438 millions in 1960-61. No doubt, as a consequence of a larger scale of investment, total output, both industrial and agricultural, increased over the Plan period as a whole, though there had been shortfalls in particular years. If total output increased, total real income also increased ; but in the absence of an equivalent rise in saving from the marginal increment of income, as is usually the case in an under-developed economy, there was an excess demand for consumer goods, both food and manufactured, the prices of which tended to rise. The economy experienced in fact an excess demand inflation resulting from an investment-saving disequilibrium in the ex ante sense.

Not only the prices of food articles but also those of industrial raw materials of agricultural origin showed substantial rises. The explanation is to be found in the fact that in the course of economic development, agricultural raw material input becomes an increasing proportion of final industrial output and

¹¹ *Third Five Year Plan*, App. A, Statement A-1, p. 733.

¹² *Ibid.*

¹³ *Ibid.*

thus the demand for agricultural output as a whole tends to grow at a rapid rate. Under these circumstances prices of agricultural raw materials tend to rise if their output fails to rise appropriately to meet this growing demand. The movements of the price indices of the important groups of articles during the period 1956-61 are summarised in the table on page 66.

The uptrend in prices resumed by the general index since June 1955 continued throughout the Second Plan period. Barring a slight decline of nearly 0.2% from March 1957 to March 1958, the general index recorded a price rise in each of the remaining four years, the extent of rise being 7.6% in 1956-57, 6.6% in 1958-59, 5.7% in 1959-60 and 7.2% in 1960-61.

An interesting feature of the price situation during this period is the preponderance of food prices in the rise of the general index up to 1959. In the first year of the Second Plan, the general index rose from 98.1 in March 1956 to 105.4 in March 1957 i.e., by 7.6%. In this rise, the share of food prices alone was 10%, that of industrial raw materials 7% and of manufactures only 3%. Similarly, between March 1958 to March 1959, the general index was higher by 6.6%; but food articles group recorded a rise of 11% as against a rise of 4.4% of industrial raw materials and 0.5% of manufactures. Taking the first three years of the Second Plan together, March 1956 to March 1959, it will be found that the general index moved up by 14.5% and to this rise, the contribution of food prices turned out to be the largest by 22.6% as against 6.2% of industrial raw materials and 5% of manufactures. It was only in 1959-60 for the first time since 1950-51 that the relative pull of food prices in raising the general index ceased and industrial raw materials and manufactures emerged as more important contributory groups to the rise in the general price level. This trend was visible in the next year 1960-61 also (Percentage increases of the different group indices are given in the table on p. 66). Thus, from 1950 up to 1959, food prices had consistently taken the lead in the upward phases of the price cycle. This can be easily explained by the high income elasticity of demand for food, the typical case in an under-developed economy.

Of course, the income elasticity of demand for food does not remain constant through growth. When real income per

TABLE 10
Monthly averages: (1952-53=100)

	March 1956	March 1957	March 1958	March 1959	March 1960	March 1961	Percentage change of 4 over 3	Percentage change of 5 over 4	Percentage change of 6 over 5	Percentage Change of 6 over 1
	1	2	3	4	5	6				
All commodities ..	98.1	105.6	105.4	112.4	118.9	127.5	+ 6.6	+ 5.7	+ 7.2	+30.0
Food articles ..	92.8	102.3	102.3	113.8	117.0	117.6	+11.2	+ 2.8	+ 0.4	+26.7
Industrial raw materials ..	109.4	117.3	111.3	116.2	131.9	159.1	+ 4.4	+13.5	+20.6	+45.4
Manufactures ..	102.9	106.2	107.6	108.2	116.9	129.4	+ 0.8	+ 7.4	+10.7	+25.7

capita is low, the income elasticity of demand for food remains high and as the former rises, the latter tends to decline. But usually no significant change in the pattern of consumption is to be found in an under-developed economy before quite a substantial rise in the standard of living is achieved through a rapid pace development. Therefore, in the earlier stages of development, expenditure on food continues to remain by far the largest item in total spending so that as real income per capita rises, the pressure of demand is felt most upon food articles. If against this rising pressure of demand, there is inadequacy of food production, the rise in food prices becomes intensified.

As the following table will show, the production of food grains was 6 million tons less in 1957-58 than in the previous year. In 1959-60 again, there was a decline by 4 million tons compared to the previous year's production. In the case of manufactured consumer goods on the other hand, even though there was some pressure of demand arising from the increase in money incomes consequent on higher investment, the demand was not possibly as large as for foodgrains. At the same time, the production of a number of important consumer goods showed steady and substantial increases. This explains the relative rise in food prices. In fact, the rise that took place in the price index of manufactures was mainly due to the rise in the prices of industrial raw materials of agricultural origin some of which recorded heavy declines in production. The trends in agricultural and industrial production are revealed in the following tables :
 Apart from the short-falls in agricultural production in particular years due to the vagaries of nature, there may be a chronic deficit in agricultural output in an under-developed economy because of the backwardness of agriculture. In the case of India for example, despite heavy development expenditure on agriculture, it is still in a backward state in many ways. Lands are still divided in small plots, there is still no evidence of organised large-scale farming on co-operative basis, and the agriculturist still follows the antiquated methods of production. In short, modernisation of agriculture is not within sight as yet. The result is that even when the agriculturist's income increases with the rise in agricultural prices, he cannot readily increase his output and add to national real income. On the other hand, the

TABLE 11

Index numbers of agricultural production Base 1949-50=100.

Figures relate to agriculture year ending June.

Commodity/Group	1954-55	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61
Rice-index ..	105.8	114.2	120.4	104.8	127.6	123.3	134.6
Quantity in thousands of tons ..	24,209	27,122	28,578	24,885	30,354	29,338	—
Wheat-index ..	135.4	131.3	140.7	116.5	147.1	146.5	151.0
Quantity in 000 tons ..	8,539	8,622	9,254	7,741	9,772	9,734	—
All cereals index ..	114.5	114.9	120.5	108.5	129.3	125.3	132.6
Quantity in 000 tons ..	55,327	54,923	57,383	53,004	63,631	60,514	—
Pulse-index ..	118.5	118.4	122.9	104.2	135.2	117.2	125.5
Quantity in 000 tons ..	10,474	10,871	11,369	9,507	12,872	11,236	—
Total food grains index ..	115.0	115.3	120.8	107.9	130.1	124.3	131.6
Quantity in 000 tons ..	65,801	65,794	68,752	62,511	75,503	71,750	—
Oilseeds-index ..	122.6	108.6	190.3	115.6	133.4	122.5	136.9
Quantity in 000 tons ..	5,877	5,643	6,263	6,051	6,907	6,352	—
Sugarcane-index ..	115.9	119.8	137.2	134.7	139.4	140.5	156.7
Quantity in 000 tons ..	5,546	5,979	6,847	6,871	7,113	7,579	—
Cotton-index ..	163.6	153.9	181.2	179.7	178.0	146.7	193.8
Quantity in bales of 392 lbs. each ..	4,227	3,993	4,707	4,739	4,686	3,835	—
Jute-index ..	94.8	135.8	138.7	131.0	158.6	139.8	122.9
Quantity in bales of 400 lbs. each ..	2,928	4,198	4,289	4,032	5,158	4,548	—
Coffee-index ..	151.8	196.1	204.1	229.8	241.2	245.7	252.6
Quantity in lbs. ..	—	75,784	78,860	88,770	93,035	—	—
Tea-index ..	110.4	107.2	108.7	116.9	122.9	124.0	124.9
Quantity in lbs. ..	—	627,669	686,499	677,567	699,200	—	—
Rubber-index ..	127.6	146.1	143.4	140.1	143.4	137.9	155.5
Quantity in lbs. ..	—	40,549	51,833	47,490	54,306	54,422	—
General index of all commodities ..	117.0	116.8	124.0	114.6	132.3	127.2	135.0

Source: Area and production of principal crops in India, and Third Five Year Plan.

TABLE 12

Index numbers of industrial production

(Base : 1951=100)

Commodity	1955	1956	1957	1958	1959	1960
Sugar ..	143.0	166.5	185.5	175.6	186.8	228.7
Salt ..	109.0	119.5	132.7	151.3	114.5	123.8
Vegetable oil products (Vanaspati)	151.3	148.3	174.9	171.3	183.8	192.8
Cotton textiles ..	111.9	117.5	115.6	108.9	111.5	115.4
Footwear (leather)	97.1	114.3	129.6	132.4	144.2	160.9
Paper & Paper boards ..	140.2	146.6	159.3	191.8	222.9	257.6
Footwear (Rubber)	151.4	156.6	160.0	159.1	170.4	193.6
Tyres ..	138.2	151.4	170.1	193.0	221.9	253.2
Matches ..	106.6	106.6	100.1	108.3	112.3	114.5
Soap ..	118.7	132.1	133.8	148.0	155.8	166.2
Glass & glassware	127.8	148.7	162.3	196.3	219.9	225.1
Iron & Steel ..	113.3	119.4	119.3	119.1	163.1	208.8
Electric lamps ..	156.2	198.0	213.6	196.1	224.5	266.7
Electric fans ..	132.8	159.5	246.9	299.1	341.4	466.3
Automobiles ..	103.7	144.3	143.4	120.3	163.8	232.0
Bicycles ..	429.8	581.0	691.8	798.6	867.0	919.5
General index ..	122.4	132.6	137.3	139.7	151.9	170.3

Sources : *Monthly statistics of production of selected industries of India* and Planning Commission.

increase in his income tends to raise his own consumption demand for food. To the extent he stocks food for his own consumption, the marketable surplus becomes reduced. In India, no statistics are available of the actual food stocks of the cultivator for consumption purpose ; but it is a well known fact that the Indian cultivator usually brings to market only a part of his output for sale, keeping a substantial amount for his family consumption. Once food prices start rising, the cultivator may also hoard more in anticipation of still higher prices. This anticipatory hoarding also cuts the marketed surplus. This aggravates the rise of food prices to the non-agricultural sector. The rise does not end here. Its effect is soon transmitted in the manufactured goods sector also. There are two possibilities here. First, if the relative rise in food prices does not switch demand away from food to manufactured consumer goods because of a low elasticity of substitution of food for manufactured consumer goods, there would be a larger relative rise in food prices, making it more difficult to maintain general price stability. On the other hand,

the relative rise in food prices may switch demand away from food to manufactured goods. Whether food prices and the general price level will rise or not in such a situation will depend to a large extent on what happens in the labour market. If money wages are sensitive to movements in prices, these may begin to rise following the rise in food prices. To the extent money wages rise, further pressure is exerted on food prices which continue to rise. Meanwhile, costs of production in the manufactured goods industries may also be affected by the rise in money wages. Wage costs will tend to rise if there is no appropriate increase in labour's productivity. Costs of production in the manufacturing industry may also rise because of the rise in the prices of industrial raw materials. Thus, what happens to manufactured goods prices in the long run depends partly on wage costs and partly on raw materials costs. The rise in costs of production in manufacturing industry caused by the rise in prices of raw materials and labour may not prevent any later fall in manufactured goods prices and may even cause them to rise. Once costs have risen, manufactured goods prices now come to be determined not simply by demand but more importantly by cost conditions. The inflation that originates in the form of higher food prices as a result of general excess demand gets transformed at a later stage into a general cost inflation.

In the case of India it is found that in the two years 1959-60 and 1960-61, both agricultural production and industrial production increased considerably. Foodgrains production also showed a substantial rise. But in spite of considerable increase in production in different fields, inflationary upsurge in general prices continued unabated. Although food prices remained more or less steady showing only a nominal rise in each of the two years 1960 and 1961 the indices of industrial raw materials and of manufactures recorded substantial rises. Therefore, the rise in the general index by 5.7% and 7.2% in these two years was induced by the rise in the prices of industrial raw materials and manufactures. Thus, it is clear that even a substantial increase in the production of manufactured goods did not lead to any decline in their prices. This may perhaps be explained by the rise in the costs of production of these goods induced by the continued rise in the prices of food grains and of raw materials in the earlier years. The relatively

greater rise in food prices in the previous years induced higher money wages and higher wages together with higher raw materials prices raised the costs of production in the manufacturing industry.

In short, the failure of food supply per capita to increase at a rate appropriate to the increase in real income per capita together with the high income elasticity of demand for food put an upward pressure on food prices which set off a wage-price spiral¹⁴. On the assumption of a high income elasticity of demand for food in a free consumer market, food prices rose relatively to other prices with the increase in money incomes and whenever this involved an absolute rise in food prices, general inflation became the inevitable consequence. The Government of course tried to prevent the inflation through state procurement of food grains and opening of fair price shops. These remedies, however, require a system of rationing and a strict control over black market activities, both of which require considerable administrative machinery and expertise which are lacking in India as in other under-developed economies. The Government could, of course, fix a ceiling of food prices forcing the farm sector to sell its output at prices below those that would prevail in a free market. This remedy, however, by depriving the farmer of the incentive to increase his output, tends to perpetuate the fundamental inflationary force. Even if prices are restrained for some time, in a growing economy the farm sector must ultimately be induced to expand its output, and in a mixed economy where agriculture is not state-controlled, this can hardly be done without allowing food prices to rise. Hence, in the end the Government has to permit some rise in prices to solve its basic problem.

The above analysis suggests that food prices act as the prime mover in the spread of inflation. Even so, we should not ignore the fact that inflationary forces may emerge in the non-agricultural sector independently of the rise in food prices. As part of the increased income of the industrial workers and the agriculturists is directed towards non-agricultural goods (apart from any transfer of demand from food to manufactured consumer goods due to relative rise in food prices), the demand for these goods

¹⁴ This is also the experience of many Latin American countries particularly Chile and Argentina: see G. Maynard's article, *Inflation and growth: Some lessons to be drawn from Latin American experience*, *Oxford Economic Papers*, New Series, Vol. 3, June 1961.

tends to grow higher. But the possibility of increasing non-agricultural output is not much greater than in the case of agricultural output. This is so because the consumer goods industries in an under-developed economy may not possess much excess or idle capacity. The result is that though the tertiary increase in money incomes takes place (as a consequence of spending by agriculturists), there is no corresponding increase in either output or employment. From the initial expenditure on investment, every successive round of spending increases money income, but not real income or employment, at least to any significant extent. Even if some excess capacity of capital equipment or even of land exists, as is normally found, many of the complementary resources necessary to expand output may be in short supply. It may be impossible to increase their supply in the short-run or possible only with considerable increases in prices. There may be a number of "bottle-necks", such as electricity, fuel, raw materials, imported and domestic, transport etc. Because of these bottle-necks, industries are not in a position to expand output to the desired level or can expand output only at higher costs. It may be remembered here that in India the Second Plan for the first time sought to create the industrial base by setting up a number of basic and key industries which, in future, will provide raw materials to other industries. Hence it is likely that many of the bottle-necks usually found in under-developed countries existed in India during the years of the Second Plan. This raises the presumption that the expansion in industrial output during this period was secured at increased costs of production.

It may be useful here to distinguish between the criterion of what Keynes called 'true inflation' applicable to an advanced economy and that which is applicable to an under-developed economy. As is well known, it is the full-employment inelasticity of output relative to rising effective demand that constitutes the criterion of 'true inflation' in the Keynesian sense although Keynes admits the possibility of some inflation even before the full-employment level due to specific bottle-necks¹⁵. In an under-developed economy on the other hand, since unemployed resources of every type are not readily available in the short-run

¹⁵ *General Theory*, pp. 296-302.

even with moderate price increases, the correct criterion of 'true inflation' is to be found in inelastic full-capacity output. For in such an economy, as Kurihara has put it, the lack of real capital, not of labour, is the ultimate bottle-neck to 'real' expansion relative to 'monetary expansion'¹⁶.

What was the behaviour of money supply during this period? The growth of money supply in the context of development derives its importance from the inflationary impact that it may have on prices. Given the rate of growth of output, there is an appropriate relationship between the growth of output and the growth of money supply; if the latter proceeds at a faster rate than the former, inflation may ensue. Assuming that inflation in the end does not promote growth, an expansion of money supply not warranted by the growth of national output is to be deprecated. If, on the other hand, money supply does not expand at a rate appropriate to the increase in national output, there may be deflationary tendencies hindering the process of growth.

In fact, there may be several reasons for which an expanding money supply may be necessary in a developing economy. Since economic development is a continuous process, investment is also continually undertaken so that in every successive period the total physical product may be reasonably expected to be higher than in the preceding period. The increments in physical output will require corresponding increases in money supply for transactions purposes. Secondly, economic development leads to the expansion of the monetized sector of the economy which in turn creates a further increase in the demand for money. Thirdly, as money incomes rise, the money/income ratio, the Marshallian K, also tends to rise. In developed countries, the process of development has been characterised by some increase in holdings of cash balances, following rising money incomes. People have been found to be holding larger cash balances as their money incomes rise partly to enjoy greater ease in financing transactions and partly to satisfy an increasing desire for precautionary balances. This increasing demand for cash balances on the part of the public has the effect of absorbing some part of the money supply.

¹⁶ K. K. Kurihara, *The Keynesian Theory of Economic Development*, p. 145; also John H. Adler, "Deficit Spending and Supply Elasticities", *Indian Journal of Economics*, Vol. XXXVII No. 144, July 1956, p. 29.

The fact is that the increase in money supply has to be viewed in the perspective of the natural requirements of a growing economy with increasing real income and judged by this criterion, an expansion of money supply by itself does not constitute any danger to the stability of the economy. In the light of these observations, we may now examine the growth of money supply during the year 1956-57 to 1959-60.

Money supply during 1956-57 to 1959-60

Over this period increase of money supply was more spectacular, the annual increase of money supply being Rs. 129 crores in 1956-57; Rs. 76 crores in 1957-58; Rs. 110 crores in 1958-59 and Rs. 202 crores in 1959-60.

The rate of expansion of money supply also rose progressively from 3.3 percent in 1957-58 to 4.6 percent in 1958-59 and to 8.1 percent in 1959-60. During the four years of the Second Plan the aggregate expansion amounted to Rs. 517 crores or 23.7 percent as compared to Rs. 205 crores or 10.3 percent only during the entire First Plan period. The relevant data in this connection are given below :—

TABLE 13
Money supply with the public
(Crores of rupees)

	Variations during the First Plan period 1951-52 to 1955-56	Variations during				Total of (2) to (5)
	1956-57	1957-58	1958-59	1959-60		
	1	2	3	4	5	6
1. Currency with the public	+174 (+13.0)	+51 (+3.4)	+50 (+3.2)	+118 (+7.3)	+138 (+8.0)	+357 (+23.7)
2. Deposit money	+32 (+4.8)	+77 (+11.4)	+26 (+3.4)	-8 (-1.0)	+65 (+8.4)	+160 (+23.5)
3. Money supply with the public	+205 (+10.3)	+129 (+5.9)	+76 (+3.3)	+110 (+4.6)	+202 (+8.1)	+517 (+23.7)

Figures in brackets are percentage variations.
Source : *Report on Currency & Finance, 1959-60.*

Component-wise, although the share of currency in total money supply had been, as usual, twice as large as that of deposit money, one noticeable feature during this period was the remarkable expansion in the deposit-money component of money supply. While for the entire First Plan period deposit money expanded by 4.8 per cent, it increased by 23.5 percent during the first four years of the Second Plan or by about 6 percent on an annual average. As the above table shows, during 1956-57 to 1959-60, the percentage increase in deposit money was almost the same as that of currency with the public, the expansion in the two components being respectively 23.5% and 23.7%. With increasing importance of the deposit-money component in the total money supply, the Reserve Bank will have to be more vigilant over the lending operations of commercial banks.

The normal seasonal pattern of the movements of currency and deposit money, except for the war years, had been generally an expansion in the former accompanied with a contraction in the latter in the busy season and vice versa in the slack season. But during the years 1956-57 to 1959-60, one does not come across this trend. Between 1956-57 and 1959-60, there was not a single busy season when deposit money recorded a contraction. On the contrary, in one out of these four years, i.e., in 1957-58 deposit-money actually increased both in the busy season and in the slack season. Moreover, for all these years, as during the last two years of the First Plan, the busy season expansion of money supply as a whole grew in magnitude while the slack season contraction was less pronounced. Seasonal variations in money supply are given in the table on page 76.

Although over the period money supply expanded from year to year, the rate of expansion was not uniform. Among the factors which brought about the expansion in money supply during this period, the deficit on Government account continued to be the most important although its incidence in 1959-60 was much smaller than in the preceding two years and slightly less than in 1956-57. On the other hand, the expansionist impact of bank credit to the private sector in 1959-60 was much larger than in the previous two years and only slightly less than in 1956-57. For purposes of analysis of money supply with the public, monetary transactions may be divided into three broad categories: (a)

TABLE 14

(In crores of rupees)

	1956-57		1957-58		1958-59		1959-60	
	Slack	Busy	Slack	Busy	Slack	Busy	Slack	Busy
1. Currency ..	—	96.7	—89.5	+142.9	—87.1	+220.3	—57.1	+201.0
2. Demand liabilities of banks ..	—	7.8	+4.8	+24.2	—71.2	+68.7	—53.0	+73.3
3. Other deposits with the Reserve Bank ..	—	1.7	+2.1	+0.1	+1.5	+2.0	—	0.5
4. Total money supply ..	—105.1	+239.4	—82.7	+167.3	—156.9	+291.0	—110.6	+277.2

Source : Report on Currency & Finance, 1959-60.

transactions with the foreign sector, as indicated roughly by the net changes in foreign assets held by the Reserve Bank, (b) transactions with the banking sector as represented by expansion of bank credit to the private sector, adjusted for changes in time liabilities of banks, and (c) transactions with the Government; Government's deficit in its transactions with the public is almost entirely covered by resort to bank credit, which includes not only extension of Reserve Bank credit to Government (which takes the form of purchases by the Bank of Government Securities, mostly ad hoc Treasury bills, rediscount of Treasury bills and grant of loans and advances to Government), but also investments by banks in Government securities as well as changes in Government balances. The relative importance of the different factors affecting money supply during 1956-57 to 1959-60 may be seen from the following table:

TABLE 15
Variations in Money Supply with the Public during
1956-57 to 1959-60
(Crores of Rupees)

	1956-57	1957-58	1958-59	1959-60
A. Money supply with the public				
1. Currency with the public	+ 51.4	+ 50.1	+117.9	+137.5
2. Demand liabilities of banks	+ 77.5	+ 17.6	- 7.4	+ 62.2
3. Other deposits with the Reserve Bank of India	- 0.4	+ 8.2	- 0.6	+ 2.5
4. Total money supply with the public (1+2+3) ..	+128.6	+ 75.9	+109.9	+202.3
B. Factors affecting money supply (a)				
1. Bank Credit to Govt. (i+ii+iii+iv) — (v vi)	+299.7	+495.6	+531.4	+254.9
(i) Rupee securities held by the Reserve Bank of India ..	+280.2	+403.4	+133.4	+151.6

TABLE 15—(Continued)

VARIATIONS IN MONEY SUPPLY WITH THE PUBLIC DURING 1956-57 TO 1959-60 (Crores of Rupees)				
	1956-57	1957-58	1958-59	1959-60
(ii) Loans & advances to Govts. by the Reserve Bank of India ..	+ 7.7	+ 13.6	+ 3.5	— 2.4
(iii) Rediscount of Treasury Bill ..	— 9.3	+ 4.7	— 2.5	+ 28.4
(iv) Investments of banks in Govt. securities	— 11.8	+ 80.6	+ 174.4	+ 102.9
(v) Central Govt.'s deposits with the Reserve Bank of India ..	— 2.8	— 16.2	+ 5.5	+ 9.3
(vi) State Govt.'s deposits with the Reserve Bank of India ..	— 30.1	+ 22.9	— 28.1	+ 16.2
2. Foreign Assets held by the Reserve Bank of India (net of borrowings from and repayments to I.M.F.) ..	— 274.1	— 294.3	— 53.9	— 5.2
3. Public's net indebtedness to the Banking system (1-11) ..	+ 89.4	— 171.2	— 131.5	— 67.1
(i) Bank credit ..	+ 152.0	+ 66.3	+ 64.4	+ 146.2
(ii) Time liabilities of banks ..	+ 62.6	+ 237.5	+ 195.9	+ 213.4

It will be seen from the above table that throughout the period Government's budgetary deficit, represented here by Bank credit to Government, continued to be the major source of monetary expansion, although the deficit, in 1959-60 was much smaller at Rs. 255 crores, as compared to Rs. 331 crores in 1958-59 and Rs. 496 crores in 1957-58.

Notes : (a) Figures are gross variations ; no adjustments have been made in respect of extraordinary transactions.

(b) Figures in item B(3) (ii) include P.L. 480 deposits with the State Bank of India and those in item B (1) (iv) include the investment of these deposits by the Bank in Govt. securities. For these reasons, the figures overstate the expansionist effect of the extension of Bank credit to Government and the contractionist effect of increase in banks' time liabilities.

The impact of the balance of payments deficit which had a marked contractionist influence on money supply since 1956-57 was narrowed down to a negligible amount in 1959-60. The payments deficit, as measured by the decline in foreign assets held by the Reserve Bank, amounted to only Rs. 5 crores in 1959-60, as against Rs. 274 crores in 1956-57, Rs. 294 crores in 1957-58 and Rs. 54 crores in 1958-59. The improvement noticed in the balance of payments position in 1959-60 was accounted for mainly by the drastically reduced level of imports which, at Rs. 924 crores, were the lowest in the Second Plan period. Exports at Rs. 623 crores were also higher by Rs. 47 crores than in 1958-59 and by Rs. 29 crores than in 1957-58, but lower by Rs. 12 crores than in 1956-57. The impact of recessionary tendencies abroad which had affected India's export performance in the previous two years had worked itself off by 1959-60 and the various export incentives introduced since 1958 began to yield dividends this year.

Bank credit to the private sector recorded a sharp expansion of Rs. 146 crores in 1959-60 which was more than double that in 1957-58 (Rs. 66 crores) and in 1958-59 (Rs. 64 crores) and only slightly less than that in 1956-57 (Rs. 152 crores). Of course, there was also a substantial rise in time liabilities of banks offsetting the expansionist influence of the increase in bank credit to the private sector. But much of the rise in time deposits during the period 1956-57 to 1959-60 was due to the accrual of P. L. 480 funds to the State Bank. It may be noted here that strictly speaking, the counterpart funds created in favour of the U. S. Technical Mission in India on account of P. L. 480 imports since 1956-57 and deposited mainly in the form of time liabilities with the State Bank of India cannot be considered as deposits owned by the public. If these deposits as well as the corresponding investments in Government securities by the State Bank are excluded from the analysis of money supply with the public, the expansionist effect of bank credit to Government as well as the contractionist effect of banks' time liabilities will be appreciably smaller.

Total scheduled bank credit increased from Rs. 781.64 lakhs in 1956-57 to Rs. 987.49 lakhs in 1959-60 or by 56 percent, the aggregate growth of bank credit in the first four years of the

Second Plan being 48 percent. This growth in bank credit reflected the sharp growth of deposits which increased from Rs. 1,094,91 lakhs in 1956-57 to Rs. 1,786,78 lakhs in 1959-60 or by about 63 percent. In fact, the rising trend in aggregate deposit liabilities noticed since 1951-52 was further accelerated during the period 1956-57 to 1959-60, the credit-deposit ratio in March, 1960 being about 70 percent, if P. L. 480 deposits are excluded. The main features disclosed by the trends in the relevant scheduled bank data are illustrated in the following table overleaf.

From the table it will be clear that by 1959-60 there was very heavy pressure on the banking system as will be evident from the fact that borrowings from the Reserve Bank increased from Rs. 17.81 crores in 1958-59 to Rs. 19.42 crores in 1959-60, cash reserves declined from Rs. 124.3 crores to Rs. 120.62 crores and the cash ratio fell from 8.0 percent to 6.8 percent. Investments of course recorded a substantial rise in 1959-60 but if allowance is made for the fact that the State Bank of India invested the P. L. 480 funds in Government securities, the rise will not appear to be spectacular. It may be noted here that in the busy season of 1959-60 investments actually declined by Rs. 52.49 crores. The seasonal trends in respect of bank credit, total deposits, investments and borrowing from the Reserve Bank are indicated in table 17.

The 1959-60 busy season witnessed the largest expansion of bank credit as compared to the earlier periods. In the busy season of 1958-59 bank credit expanded by Rs. 181.7 crores. In the ensuing slack season, the volume of bank credit declined by only Rs. 78.95 crores so that the busy season of 1959-60 started from a larger base.

Borrowing from the Reserve Bank, since 1956-57 busy season, had also been the highest in the 1959-60 busy season. Cash ratio of the banks was also the lowest in the busy season of 1959-60 as compared to the earlier busy seasons. In fact during the eleven months of the year 1959-60, the average cash ratio amounted to 6.71 as against 8.03 in 1958-59, 8.89 in 1957-58 and 7.96 in 1956-57. In other words, banks had used up their cash resources to the maximum extent during the busy season of 1959-60. Lower cash ratio, larger borrowing from the Reserve

TABLE 16

In lakhs of rupees

	1	2	3	4	5	6	7	8	9	10
	Demand liabilities	Time liabilities	Aggregate deposit liabilities	Borrowings from Reserve Bank	Total cash & balances with Reserve Bank	Cash ratio (a)	Investment	Investment deposit ratio (b)	Total Bank credit	Credit deposit ratio
1956-57	..	643.69	451.22	63.45	87.17	8.0	359.35	32.8	781.64	71.4
1957-58	..	707.86	608.83	44.58	117.00	8.9	384.65	29.2	890.80	67.7
1958-59	..	715.73	833.14	17.81	124.30	8.0	564.90	36.5	899.17	58.1
1959-60	..	725.51	1 061.26	19.42	120.62	6.8	724.64	40.6	987.49	55.3

Source : *Report on Currency & Finance, 1959-60.*

(a) Percentage of total cash & balance to aggregate deposits.

(b) Percentage of investments to aggregate deposits.

TABLE 17
(In crores of rupees)

	Bank credit	Total deposits	Invest- ment	Borrow- ing from the Reserve Bank	Cash ratio	Invest- ment ratio
*Busy 1955-56	+164.49	+ 41.95	- 36.93	+50.35	8.1	33.4
*Slack 1956 ..	+ 3.67	+ 24.48	+ 16.09	+ 1.91	8.0	34.2
Busy 1956-57	+148.42	+133.11	- 26.96	+14.90	8.5	28.2
Slack 1957 ..	- 41.89	+143.03	+ 49.67	-42.94	10.5	28.9
Busy 1957-58	+ 89.42	+148.56	+ 50.41	- 9.92	8.8	29.4
Slack 1958 ..	-117.91	+ 64.33	+174.75	-17.59	9.3	39.3
Busy 1958-59	+181.07	+115.09	- 3.18	+24.94	7.8	35.4
Slack 1959 ..	- 78.95	+106.47	+178	-13.35	6.2	44.1
Busy 1959-60	+188.85	+130.89	- 52.49	+29.80	7.3	38.4

Bank and considerable decline in securities holding—all these indicate that there was a heavy pressure on the banks in 1959-60 busy season.

But the existence of a heavy pressure does not by itself indicate that lending by banks was excessive. In other words, the question may be raised as to whether bank credit granted on the scale was warranted or not by the volume of industrial activity during the period. It is true that in 1959 the index of industrial production recorded a rise of about 7.9 percent, no doubt a very high rate of increase recorded so far.

But during 1959-60 the average volume of bank credit had risen by about 9.8%, which is higher than the rate of increase in the index for industrial production. The general index of industrial production increased from 122.4 in 1955 to 151.1 in 1959 or by 24 percent. The volume of bank credit, on the other hand, increased from Rs. 632.46 crores in 1955-56 to Rs. 987.49 crores in 1959-60, i.e. by 56 percent. Thus, the increase in bank credit during the period was more than double the rise in industrial production. Moreover, a noteworthy aspect of bank credit during

* The slack season is from May to October and the busy season is from November to April.

1959-60 was that while the index of industrial production recorded the highest increase during 1959, a relatively smaller portion of the secured additional bank credit between the end of October 1959 and the middle of February, 1960 was granted against industrial raw materials and manufactured goods than in the same period of the preceding two years. In these two years about 83 to 84 percent of the secured bank credit was devoted to these two purposes, while the ratio was only 63 percent in 1959-60. This shows that the substantial rise in bank credit during the year was not fully in response to the genuine demand arising out of increased industrial output.

It may be remembered here that over the First Plan period, there was no net rise in the price index despite a considerable expansion in money supply. But the story seems to be different during the period 1956-57 to 1959-60. The growth of national income and of money supply, movements of income velocity and the requirements of money supply during 1956-57 to 1959-60 are illustrated in the following table.

TABLE 18

	National income at current prices (In crores of rupees)	Money supply (In crores of rupees)	Income velocity (1÷2)	Require- ments of money supply (1÷income velocity of 1952-53)	Excess (+) or deficit (-) of money supply in relation to requirements
	1	2	3	4	5
1956-57 ..	11,310	2313	4.88	2019	+294
1957-58 ..	11,390	2390	4.76	2034	+356
1958-59 ..	12,600	2500	5.04	2250	+250
1959-60 ..	12,840	2705	4.74	2293	+412

With income velocity¹⁷ at 1952-53 level, there was for each year between 1956-57 and 1959-60 an excess of money supply in

¹⁷ The income velocity for 1952-53 has been found to be 5.60 the national income at current prices and money supply being respectively Rs. 9820 crores and Rs. 1753 crores.

relation to actual requirements. Over the same period, i.e., between March 1956 and March 1960, the wholesale price rose from 98.1 to 118.9 or by about 21.4%. As already shown earlier in this chapter, during this period there was not a single year when the index of any of the main 'groups' of articles recorded a notable decline. Of course there may have been specific causes of the rise in prices of individual commodities and hence the cause of price rise may not be traced solely to monetary inflation. Thus, one may point out that the prices of raw jute, sugar and cotton in the 'industrial raw materials' group rose in 1959-60 mainly because of the fall in their output in 1958. Groundnut prices rose partly because of the failure of production to keep pace with the increase in demand and partly owing to larger export quota issued by the Government as an export promotion measure. Nevertheless, the coincidence between the increase in money supply and the rise in prices is striking. In fact, since 1949-50, between fluctuations in money supply and those in prices, the former had consistently taken the lead except in the year 1954-55 when an expansion of money supply was accompanied by a decline in prices. This recession may be explained by favourable domestic supply conditions. In every other year within the First Plan period increasing money supply was followed by rising prices.

Money supply with the public declined sharply in 1951-52 and to a smaller extent in 1952-53, and the recession in prices in 1952-53 was spectacular. Opposite trends are to be found since the middle of 1955. Money supply increased from Rs. 1977 crores in June 1955 to Rs. 2184 crores in March 1956 or by about 10 percent, and in the course of these nine months the general price index rose by about 15 percent. Again, between 1955-56 and 1958-59, money supply increased by 14 percent and the general price index went up by 21 percent. During 1956-57 and 1959-60, the largest expansion of money supply took place in the year 1959-60 which was also the year that recorded a sharp rise in prices, the wholesale index being 5.7% higher over that in 1959. Similarly, the relative stability of the price level during March 1957 to March 1958 coincided with a relatively smaller expansion of money supply of Rs. 76 crores only or by 3.3% in 1957-58.

INFLATION AND PRICE STRUCTURE

The analysis in the preceding chapter has shown that the inflationary impact of the growth process in India appeared first and in the initial stages at least, most in respect of food prices and industrial raw materials prices. In other words, in a period of economic development in an under-developed country, inflation may originate primarily from the agricultural sector but the relative rise in foodgrains prices and raw materials prices may later on trigger off a general cost inflation in the economy. This makes the examination of the sectoral price relationships more important than that of merely the movements of the general price index in a study of growth inflation. In fact, the economic behaviour of the aggregate depends very often on the economic behaviour of its component units. An examination of individual prices is also necessary for the reason that relative movements of individual prices may have an important bearing on economic development. The allocation of resources as determined by relative prices is bound to influence the pattern and rate of economic growth. Similarly the pattern of growth will have its repercussions on the system of relative prices. Today, a vital issue in under-developed economies is the relationship between relative prices and economic growth. Professor Meade in his book 'A Neo-Classical Theory of Economic Growth' has referred to this issue as a 'central problem'. "As soon as one tries to outline the way in which a classical economic system would behave in the process of economic growth", he observes, "one comes up against a central problem, namely, what would happen to, and what would be the effect of changes in, the prices of one product in terms of another and, in particular, the price of capital goods in terms of consumption goods".¹ Price rises thus may be at once the consequence and the cause of economic growth. In the following paragraphs we shall first examine the movements of the relative price-levels as they occurred under the impact of development

¹ *op. cit.*, Preface, p. vi.

and then consider the economic implications of the positions of the relative price-levels i.e., the inter-sectoral price relationship in its relation to economic growth.

The following table will show how the prices of different groups of commodities moved under the impact of development since June 4, 1955—the date which may be said to have marked the beginning of growth inflation in India.

TABLE 1

1952-53=100

	June 4, 1955	March 1956	March 1957	March 1958	March 1959	March 1960	March 1961	Per- centage rise of 7 over 1
	1	2	3	4	5	6	7	8
All commodities	89.7	98.1	105.6	105.4	112.4	118.8	127.5	42
Food articles ..	83.7	92.8	102.3	102.3	113.8	117.0	117.5	40
Industrial raw materials ..	93.3	109.4	117.3	111.3	116.2	131.9	159.1	70
Manufactures ..	98.2	102.9	106.2	107.7	108.6	116.6	129.4	32

The table clearly shows that over the Second Plan period as a whole, food prices and the prices of industrial raw materials rose faster than those of manufactured goods. Thus, in the price inflation during this period, the imbalance in the agricultural sector was larger than in the non-agricultural sector. The reason is not difficult to see. A relatively high demand for food, especially cereals, together with a rapidly increasing demand for industrial raw materials in a growing economy on the one hand, and a relatively low supply elasticity of agricultural output on the other, explain the relative rise in agricultural prices. At a low level of income in the early stages of development, people could not consume superior goods and therefore the demand for food-grains continued to be high so that the failure of foodgrains production to rise appropriately with the rising pressure of demand inevitably caused food prices to rise. The rise in food prices, in its turn, induced at a later stage a rise in other sectoral prices. In an under-developed economy where the expenditure on food constitutes nearly two-thirds of the total consumer expenditure, a small rise in food prices tends to push all other prices in an upward direction. Since the level of prices determines the purchasing power of money and since all incomes, except profits, are fixed

in terms of money in the short period, a persistent rise in the price of an essential consumption article like food quite understandably created a demand on the part of labour for a neutralisation of the price rise by a corresponding rise in wages and salaries. Higher wages and salaries, in their turn, led to a rise in costs of production and therefore led to a further rise in prices, thus setting in motion the inflationary spiral. It may be mentioned here that in India, as a result of the Minimum Wages Act passed in 1948, the impact of the First Pay Commission on the industrial wage structure and the standardisation of wages in a number of industries during 1947-50, the index of real wages (1953=100) showed some increase in 1951. The deliberate policy of restoring the pre-war real wage level followed in the First Plan period led to a further increase of 13 to 14 percent in real wages during 1951-56 (This was, however, due partly to a fall in prices). According to the census of Manufacturing Industries, over the period 1947 to 1958 real wage (including all benefits) per worker increased by 27 percent. Costs of production of course rose also because of the considerable rise in raw materials prices, particularly of agricultural origin.

Thus the Indian experience corroborates the fact that the inflationary effect of heavy investment expenditure in an under-developed economy expresses itself in relatively wider fluctuations in agricultural prices. The degree of price fluctuations of principal agricultural commodities may be seen from the following table :

TABLE 2

		Economic Adviser's Index Number during		Percentage rise between 1955 and 1960
		1955	1960	
Cereals	..	73	106	+ 45
Rice	..	76	110	+ 45
Wheat	..	70	92	+ 31
Jowar	..	59	124	+110
Oil-seeds	..	79	144	+ 82
Ground-nut	..	71	142	+100
Cotton	..	95	113	+ 19
Jute	..	122	159	+ 30

Wider fluctuations in agricultural prices followed as a consequence of the measures of economic development. But what were the effects of these larger price fluctuations in the agricultural sector on economic growth ?

A price rise in itself is not something to be viewed with distrust. It is only when an individual price rise fails to secure an increase in output or a reduction in demand, the price rise is undesirable, because it is not performing its proper economic function. If, on the other hand, the price rise leads to an increase in supply and to a diminution of demand, a new equilibrium is reached at which price may be higher than at the initial level but lower than that reached before the emergence of the new equilibrium. In this way, a certain rise in price may prevent any further rise and when this actually happens, price may be said to perform its economic function. In other words, to fulfil their economic functions, price changes should be self-liquidating in nature by operating on the forces of demand and supply in an appropriate manner.

Did the relative rise in agricultural prices in India fulfil its economic role? Because of the high income elasticity of demand for foodgrains in India the possibility of any significant reduction in demand as a result of higher prices may be ruled out. Then the only way in which the price rise could establish a new equilibrium was by acting on the supply side. But there are many reasons for which agricultural output in a backward economy cannot readily respond to a rise in prices so that economic incentives in the form of favourable domestic prices are often found to play a relatively smaller role in agriculture than in industry. Besides seasonal and random variations in supplies, the backward techniques of production, conditions of tenure and farm size, small resources of the cultivators and absence of adequate credit facilities, all these present formidable obstacles to any sizable increase in production even in a situation of rising prices. On the other hand, very high prices, under conditions of small-scale individualistic organisation of agricultural production, may actually impair the agriculturist's incentive both to produce more and to sell more. Since the demand of the agriculturists for non-agricultural goods such as mill cloth, shoes, paper, steel and many other commodities are almost rigidly fixed by habits at least in the short period, when the terms of trade move in favour of agriculture consequent on a relative rise in agricultural prices, agriculturists need to sell a smaller amount of their own produce to get the same amount of non-agricultural goods as before. This makes the marketed supply of agricultural produce smaller. For

the same reason, the agriculturist may not have sufficient incentive to increase production. Thus the price elasticity of supply of agricultural output may be negative. The trend of agricultural production, particularly that of cereals and pulses in India will provide evidence of the fact that price incentive did not play any effective part in increasing agricultural production.

The wholesale price index of cereals (1952-55=100) rose continuously from 69 in June 1955 to 99 in March 1957—a rise of nearly 43 percent. But this did not have any effect on the 1957-58 crop. The index of cereals production actually recorded a decline of 9 percent from 119.9 in 1956-57 to 108.6 in 1957-58. Similarly, the price index of pulses rose from 77 in March 1956 to 84 in March 1957 that is, by 9 percent whereas the index of production fell from 124.5 in 1956-57 to 104.2 in 1957-58 that is, by 16 percent. Thus it is clear that a relative rise in agricultural prices during a period of development may not have any effect on agricultural output. On the other hand, it may have other serious implications. Since fluctuations in agricultural prices are larger than those in non-agricultural prices, income may be said to move in favour of agriculture when general conditions are inflationary and against it when conditions are deflationary.

Sectoral price movements may be taken to indicate the sectoral income distribution when the growth rates of the agricultural and the non-agricultural sectors are not significantly different. Between 1950-51 and 1960-61, that is, over the two Plan periods as a whole in India, while national income at current prices increased by 42 percent, the index of agricultural production (1949-50=100) recorded an increase of 41 percent.² Since both agricultural output and national income or output recorded a growth of about 4 percent per annum, it may be said that the growth rates of the agricultural sector and the non-agricultural sector had been almost the same. In view of this, price movements may be said to reflect the inter-sector distribution of income.

The question is whether a shift of income in favour of agriculture should be considered desirable from the point of view of economic development. As is well known, the major problem for a backward economy is the long-run problem of growth rather than the short-run problem of cyclical fluctuations in income; the saving/income ratio more than the aggregate effective demand

² *Third Five Year Plan*, p. 35.

seems to be the crucial factor determining the rate of growth for, there is usually no lack of consumption demand but lack of savings in such an economy. Since the average per capita income in agriculture (about Rs. 210) is less than half of that in the non-agricultural sector (about Rs. 540), the average propensity to save among the agriculturists is smaller than among the non-agriculturists. Hence, every shift of income in favour of agriculture tends to reduce the average propensity to save and hence the aggregate volume of saving. This conclusion is not upset even if it is true that the increased income consequent on the relative rise in agricultural prices goes mostly to the higher-income groups in the agricultural sector, i.e., the big land owners, the money lenders and the middlemen because these people, as will be shown later, do not usually possess the habits of saving perhaps because of their feudal outlook and habits.

Moreover, since in a period of price inflation, foodgrains prices and raw materials prices rise faster than the prices of goods sold by the non-agricultural sector, the latter has to spend a larger proportion of its income for buying agricultural products the demand for which is often relatively inelastic. Thus, the sector which is the main source of saving in society is forced to save less while the sector whose propensity to save is relatively smaller gets more income. The net effect is a decline in the level of aggregate saving. The recent trends in the growth of savings in the Indian economy will corroborate this.

The estimates³ of the Reserve Bank of India given in the table below will show that aggregate savings had been increasing

TABLE 3

Year	Current prices (Rs. crores)	Savings as % of national income at current prices
1953-54	561.48	5.4
1954-55	637.23	6.6
1955-56	814.30	8.2
1956-57	976.32	8.6
1957-58	790.60	6.9

during the four years 1953-54 to 1956-57 both in absolute terms and as a percentage of national income, but declined substantially during 1957-58 both in absolute and proportionate terms. It may be pointed out here that the wholesale price index of cereals declined sharply from 104 in June 1953 to 82 in June

³ *Reserve Bank Bulletin*, March, 1960.

1954 and to 69 in June 1955, the decline over the two years being 33.6%. Similar were the movements of the price index of industrial raw materials which declined by 17.9% between June 1953 and June 1955. Against these sharp declines in cereals and raw materials prices, prices of manufactures remained practically stable. After June 1955, however, both cereals and raw materials prices started rising rapidly and by June 1958 rose by 53.6% and 23.6% respectively whereas the prices of manufactures with their characteristic steadiness lagged far behind in the race. The movements of the index numbers of prices of the different 'groups' will be clear from the following table.

TABLE 4
INDEX NUMBERS OF WHOLESALE PRICES
Base: 1952-53=100¹

Year	Cereals	Industrial raw materials	Manufactures
June 1953	.. 104	113.7	100.1
June 1954	.. 82	103.1	101.1
June 1955	.. 69	93.3	98.2
June 1956	.. 93	112.9	103.5
June 1957	.. 104	121.4	108.6
June 1958	.. 106	115.2	107.9

In the downtrend of prices up to June 1955, the relative steadiness of manufactured goods prices against the severe declines in agricultural prices made the income in the non-agricultural sector relatively higher. Hence the saving/income ratio was found increasing during 1953-54 to 1956-57. The violent rise in agricultural prices in the upswing since June 1955 made a shift of income in favour of agriculture and this may be one of the factors leading to a substantial decline in savings in 1957-58.

The foregoing analysis clearly shows that a price rise may not play its functional role in agriculture and that the favourable terms of trade and the consequent shift of income in favour of agriculture may actually tend to reduce the aggregate savings in the economy and thus retard the pace of development.

Several policy measures may be suggested to prevent these undesirable consequences of the divergent movements of sectoral prices. One possible remedy may be substituting the demand for non-agricultural products for the demand for agricultural products. The extent of such substitutability of demand is, however, extremely limited. As already shown, non-agricultural demand for agricultural products persists even at high prices because of the

¹ *Third Five Year Plan*, p. 734.

relatively inelastic demand for the latter, while agriculturists, by habits, may not buy much more of non-agricultural goods even when their money incomes rise and the goods in question are relatively cheaper. Nevertheless, it may not be altogether impossible through constant publicity, advertisement and a more plentiful supply of non-agricultural goods to increase the agriculturists' demand for such goods. If this can be done, the marketed supplies of agricultural produce may rise and the degree of monetization of the economy may increase. But this necessitates a change in relative emphasis given at present to capital goods industries and consumption goods industries. In the interest of price stability, a little more attention may have to be given to the expansion of the consumption goods sector without at the same time curtailing the investment programme for capital goods industries.

Inter-sectoral price disparity is caused not only by relative rise in demand but also by relative shortages of sectoral output. Such measures as zoning of States, cordoning of cities, buffer stock operations, rationing, etc. have been suggested and under certain circumstances may be effective in the short run. But the long-run solution of the problem lies in removing the overall shortage of agricultural supplies from domestic sources. Besides the adoption of new techniques and provision of essential services, there is the imperative need for greater factor-mobility to increase agricultural productivity. At present, neither entrepreneurship nor know-how, neither trained labour nor capital moves freely and readily from the non-agricultural to the agricultural sector. One urgent need is the diversion of investible resources into agriculture both through public investment and through an integrated credit scheme to promote service organisations. Urban investible resources may be one source of capital formation in agriculture; utilization of local labour for such capital construction as bunds, drains, wells etc. may be another. Since both of these are dependent on organisation, investment in organisation is an urgent necessity. While it is true that investment in many sub-sectors of agriculture is hampered on account of the disabilities of tenure and farm size, it is equally true that institutional changes in these sub-sectors are a pre-condition to larger investment.

If agricultural prices cannot be kept down either by reducing the demand for agricultural products or by increasing the supply

of agricultural produce, an appropriate relationship has to be maintained between agricultural and non-agricultural prices so that no unduly favourable terms of trade for agriculture may adversely affect the growth of savings in the economy.

If the general price inflation arising out of price disparity becomes irresistible it may be necessary to allow a faster rise in interest rates, particularly the rate on Government bonds. If the annual rate of price rise exceeds the current rate of interest, savers will have little incentive to save because the annual earnings from interest will be more than offset by the decline in the real value of capital sum. For example, a general price rise of $6\frac{1}{2}$ percent per annum against a long-term rate of 4 percent on Government bonds is certainly a serious deterrent for thinking investors.

To put it in a nutshell, from the point of view of growth, a shift of income in favour of the agricultural sector consequent on a relative rise in agricultural prices has two bad effects—namely, (a) decline in marketable surplus and (b) decline in aggregate savings.

A rise in agricultural prices not only does not have any effect on increasing agricultural production, but it may actually cut into the marketed supply because with relatively higher prices of his products, the agriculturist needs to sell a relatively smaller amount of his output to buy his necessities from the non-agricultural sector the demand for which is more or less fixed. In a situation of rising prices, the agriculturist may also increase his stocks in anticipation of still higher prices. To the extent the marketable surplus is reduced, the inflationary pressure in the economy becomes further aggravated and holds a serious threat to a smooth process of development.

Moreover, because of a relatively lower average and marginal propensity to save in the agricultural sector, any shift of income in favour of this sector also militates against the growth of aggregate savings. To the extent savings decline, capital formation is retarded and progress of the economy hampered.

In view of this, steps should be taken either to prevent the rise in agricultural prices or, if that is not possible, to maintain a suitable price-relationship between the agricultural and the non-agricultural sectors so that no substantial shift of income may take place in favour of agriculture.

Chapter VI

EVOLUTION OF A GROWTH-ORIENTED MONETARY POLICY

Securing finance for the enormous investment expenditures and at the same time prevention of the emergence of inflationary pressures due to the various bottlenecks usually found in a backward economy, are the two important problems in such an economy pursuing a policy of rapid economic growth.

Since in a backward economy with a low saving/income ratio it is not possible to finance the heavy investment expenditures wholly from voluntary domestic savings, it becomes essential either to secure adequate external resources or to take resort to some amount of deficit financing. As the latter has an inflation potential, care should be taken at the same time to prevent as far as possible its inflationary impact on the economy. Monetary policy in a growing economy has, therefore, to be tailored to the needs of (a) securing sufficient investible funds, in the interest of rapid growth and (b) adopting measures to prevent the emergence of inflationary pressures in the economy, in the interest of stability.

The Second Plan envisaged an increase of 25% in national income as compared to an actual increase of 18% during the First Plan. This means that the pace of rise in national income during the Second Plan was expected to be about 39% higher than in the First Plan. To achieve this rate of increase in income without incurring the risk of an inflationary price rise, note circulation might be allowed to rise by about 36%, i.e., it might increase from about Rs. 1467 crores on March 30, 1956 to about Rs. 2000 crores by the end of the Second Plan. To secure this increase in note circulation, the minimum of reserve in gold and foreign securities that the Reserve Bank was required to hold in terms of Section 33(2) of the Reserve Bank of India Act would have been Rs. 800 crores. But the actual amount of gold and foreign securities on March 30, 1956 was to the tune of Rs. 696 crores. This implied that a large amount of foreign assets to be

earned in future had to be locked up in the Issue Department as a cover against note-issue. This, however, the country could ill afford in view of the fact that foreign exchange requirement in the Second Plan was estimated at about Rs. 1600 to Rs. 2000 crores. It was therefore proposed to vest the Reserve Bank with powers to expand the money supply in the country by liberalising the conditions of gold and foreign assets requirements in the Issue Department. For this purpose the Reserve Bank of India Act was amended in March 1956 (the Amendment Bill received the President's assent on September 1, 1956). By the amendment to Section 33(2) of the Act, the Reserve Bank was given the authority to issue currency against a minimum reserve of Rs. 400 crores in foreign securities and a minimum of Rs. 115 crores in gold coin and bullion, i.e. a total of Rs. 515 crores. The link of a ratio between reserves and note-issue was replaced by a statutory minimum reserve of gold and foreign securities in absolute terms. This was necessary to introduce greater elasticity in the supply of currency which was considered essential in the context of larger financial commitment in the Second Plan. Concurrently, Section 33(4) of the Reserve Bank of India Act was also amended in order to change the basis of valuation of gold held in the Issue Department. Prior to the amendment, gold had been valued at the rate of 8.47512 grains per rupee or Rs. 23-3-10 per tola, a wholly unrealistic price as it bore no relation to the official international price of gold. The amendment provided for the revaluation of gold at the official parity agreed to by the International Monetary Fund, i.e. at the rate of 2.88 grains of fine gold per rupee or Rs. 62-8-0 per tola. As a result of this revaluation, the value of gold held in the Issue Department increased from Rs. 40 crores to Rs. 117 crores. This change, however, was only formal and it was intended to reflect more accurately the value of India's gold reserves according to the official parity of the Indian rupee. Simultaneously with the revaluation of gold, the minimum gold reserve had been raised from Rs. 40 crores to Rs. 115 crores. These provisions regarding the maintenance of gold and foreign securities were further amended by the Reserve Bank of India (Amendment) Ordinance, issued on October 31, 1957, subsequently replaced by the Reserve Bank of India (Amendment) Act passed in November 1957. This amendment required the aggregate value of gold coin and gold

bullion and foreign securities to be never less than Rs. 200 crores of which the value of gold coin and gold bullion must be Rs. 115 crores. This was necessitated by the sharp and continuous decline in the foreign exchange reserves of the Reserve Bank of India since the beginning of April 1956 and the expectation that this trend would continue in view of the foreign exchange requirements in the Second Plan period.

The Reserve Bank of India (Amendment) Act of 1956 thus transformed the system of note-issue in the country and increased the power of the Central Monetary Authority to create currency to meet deficits of the Government brought about by development plans. Thus, this enabling measure gave recognition to the Government's policy of deficit financing in the context of economic development.

But the Reserve Bank was fully alive to the dangers inherent in such a policy. It observed in its Report¹ to the Central Government that "deficit financing provides no easy substitute for sustained and substantial efforts to mobilise resources for development. It is a double-edged weapon which may be employed, within limits, to help development; but may hinder it, if used to excess . . . In such context, the essential function of the banking system would be to provide the necessary expansion in bank credit to facilitate the growth in productive activity, while preventing, at any stage, a lapse into undue credit expansion and inflation".

To prevent this possible danger of inflation and rising prices, the Reserve Bank of India (Amendment) Act of 1956 by Section 42 of the Act gave power to the Bank to vary the reserve requirement of scheduled banks within the range of 5 to 20 per cent in respect of demand deposits and 2 to 8 per cent in respect of time deposits and to require the banks to maintain in respect of any increase in deposits with them after a specified date additional reserves which, if thought necessary, might be 100 per cent of such increases. This was intended as a lever in the armoury of the Reserve Bank to control the forces of inflation in bank credit as a result of money supply released in terms of the earlier amendment of Section 33(2) of the Act. The Reserve Bank, however, had no occasion to exercise this weapon until March 1960. Meanwhile selective or qualitative credit control was being resorted to since the beginning of the Second Plan.

¹ Report, 1955, pp. 14-15.

There was no lack of awareness on the part of the Monetary Authorities that as a result of enormous growth in public investment expenditure in a backward economy, there is every likelihood of the emergence of bottlenecks in particular lines of production and of the growth of inflationary pressures in the economy; that during such periods bank credit may be utilised to an increasing extent to hoard essential goods in short supply thereby accentuating their price rise and that in such a situation, it may become necessary to restrict the use of bank credit for financing speculative holding of goods without putting any pressure on other desirable uses of bank credit.

In exercising quantitative credit control, the aim of the Central Bank is primarily to influence the cost and availability of bank credit in general without regard to its distribution in particular channels. But the problem of credit control in India, as elsewhere, particularly during the period of development, is not only to regulate the total volume or cost of credit but also to prevent its overflow in particular directions. All demands for bank credit may not be legitimate in the sense of being indispensable to meet the genuine demands of development. Some of them may be for economically unimportant and socially harmful purposes. The danger of such 'illegitimate' uses of bank credit becomes particularly serious when money supply in the economy expands under the pressure of the growth in investment expenditure and prices tend to rise owing to the emergence of bottlenecks in production. On such occasions it becomes profitable for producers or traders to hold on to stocks in a rising market and if bank credit is freely supplied to them for financing such holding of stocks, hoarding and profiteering are encouraged. This aggravates the tendency of price rise and the rising pressure of bank credit for speculative purposes further expands money supply and exerts its unhealthy pressure on the economy. In the context of planning and development, the use of selective credit control becomes necessary to canalise bank credit to socially desirable and economically useful purposes to fulfil the broad objectives of the Plan.

Out of these considerations, the choice naturally first fell on selective credit control measures which were undertaken to restrain those types of bank credit which had the greatest inflationary impact without affecting other sectors.

SELECTIVE CREDIT CONTROL

Since the beginning of the Second Plan, the Reserve Bank of India has been actively exercising selective credit control over advances of banks against essential food articles such as paddy and rice, wheat and other foodgrains, sugar, ground-nuts and other oilseeds and lately shares. Rising money incomes, generated by large-scale development expenditure, had their repercussions on the demand for foodgrains at a time when the rate of growth in food production had slowed down on account of unfavourable weather conditions. As soon as this relative shortage in the supply of foodgrains tended to raise their prices, the danger of speculative withholding of stocks of foodgrains became apparent. So the Reserve Bank adopted selective credit control measures for preventing bank-financed speculative holding of foodgrains. For a limited period in 1956-57 advances against cotton textiles were also restricted. The first directive was issued on May 17, 1956, in respect of advances against paddy and rice. Subsequently 23 more directives were issued up to October, 1960, some in replacement or modification of the previous ones, the latest in this respect up to 1960 being a directive in respect of paddy and rice issued on October 8, 1960*.

The power to exercise selective credit control over bank advances was granted to the Reserve Bank of India in 1949 under the Banking Companies Act, which authorised the Reserve Bank to issue directives for the purpose of determining the policy to be pursued by the banks regarding the grant of advances, the purpose or purposes for which advances might be granted, the margins to be maintained in respect of secured advances and the rates of interest to be charged. Attempts were, however, made from time to time since 1943, to exercise some control over the use of excessive bank credit for speculative purposes, either on the stock Exchanges or in the Bullion Market. Letters were issued or warnings were given to the banks, requesting them not to grant credit for these purposes. There was, however, no attempt to

* A Chart showing the provisions of the various directives is appended to this chapter.

regulate margins with respect to such loans or to the aggregate amount of loans of this type. Methods of selective credit control came to be used regularly from the year 1956 when the continuously rising food prices caused fears of inflation.

Background

Certain factors working in the Indian economy prior to the adoption of selective credit control should be kept in mind before a detailed study of the impact of this method of control was made. Though the First Five Year Plan came into operation from the year 1950-51, it was only during the later stages that the total investment expenditure of the government became significant. Thus as against Rs. 343 crores in 1953-54, and Rs. 476 crores in 1954-55, the aggregate investment expenditure rose to Rs. 614 crores in 1955-56, Rs. 633 crores in 1956-57 and Rs. 884 crores in 1957-58. An increasingly large part of this expenditure came to be met through deficit financing—Rs. 36 crores in 1953-54, Rs. 94 crores in 1954-55, Rs. 157 crores in 1955-56, Rs. 253 crores in 1956-57 and Rs. 496 crores in 1957-58. Larger plan outlay gave impetus to the expansionary trend in the economy and there was a sharp rise in the demand for bank credit. In the busy season of 1955-56, there was a record expansion of bank advances by Rs. 180.31 crores, one of the highest figures in any year. The decline in the total volume of bank advances that took place in the ensuing slack season was relatively small by Rs. 34 crores only. The next busy season from October 1956 to May 1957 witnessed again a further expansion in bank credit by Rs. 181.7 crores and on May 17, 1957, the volume of loans and advances of the Scheduled Banks stood at an all time high of Rs. 937.38 crores. There was also an increase in the aggregate money supply from Rs. 1794.0 crores on the 31st March, 1954, to Rs. 2240.2 crores on the 31st August, 1957—an increase of about 25 percent in three and a half years. The expansion in money supply would have been larger but for the large deficit in the balance of payments in 1956 and 1957. Against the background of these forces one has to examine the working of the selective credit control measures. By May 1956 when the first directive was issued by the Reserve Bank, the general index number of prices had risen in one year by 13 percent; most of this rise in

the general index was accounted for by the rise in the price index for cereals which recorded a rise of more than 34 percent during this period. The general feeling in the country was that this rise was due to speculative holding of foodgrains financed by bank loans. An examination of the Statements submitted by the banks to the Reserve Bank seemed to corroborate this idea. The amount of bank advances against rice and paddy increased from Rs. 11.64 crores at the end of March 1955 to Rs. 24.62 crores on the same date in 1956, and further to Rs. 38.67 crores in May 1956, indicating a rise by 225 percent in 14 months. The data collected by the Reserve Bank from 20 large Scheduled banks, which were responsible for 60 percent of the total bank loans, showed that the stocks of rice and paddy pledged or hypothecated with these banks increased from 492.9 thousand tons in May 1955 to 815.2 thousand tons in May 1956—an increase of 65.3 percent against a rise in the total output of this commodity by only 6.8 percent between 1954-55 to 1955-56¹. So on May 17, 1956, the Reserve Bank issued a Directive under Sec. 21(2) of the Banking Companies Act to the Scheduled Banks, requiring them, first, to raise all existing margins in respect of advances against rice and paddy by 10 percent; secondly, not to increase any existing credit limit or to grant fresh credit limits in excess of Rs. 50,000 to any person or firm. This was accompanied with a request to banks to bring down the aggregate of such advances to sums not exceeding 25 percent above the amount granted in the corresponding week of 1955. Thus for the first time in the history of the Reserve Bank of India, the Federal Reserve Board technique of raising or lowering the margin requirements in respect of particular types of loans was taken resort to. This was, however, coupled with an attempt to fix ceilings on such advances.

Technique of selective control device

Before going into the details of how far the various measures adopted under the selective control device were implemented in order to assess the impact of the selective control, it will be better to put in one place the salient features of the various directives issued from time to time.

The salient features were as follows :

¹ Report of the Foodgrains Enquiry Committee. 1957, p. 40.

They applied to all scheduled banks only, the non-scheduled banks and co-operative credit institutions being left out of the purview of the control*.

The directives were simple to begin with but as experience was gained, were made more rigorous as well as flexible. For example, the purpose of the directives issued in 1956 and early 1957 covering paddy, rice, wheat and other foodgrains sought to bring about a reduction in advances through prescription of minimum margin requirements and by prohibiting any increase over existing credit limits or grant of fresh ones beyond Rs. 50,000. Banks were also asked to reduce the level of advances but this was in the nature of a request and not a mandate. Later, when it was found that mere raising of margins did not provide a sufficient deterrent to traders, modifications were made and the directives relating to advances against foodgrains issued since mid-1957 contained two-pronged provisions, viz., increased margins and mandatory provisions for maintaining advances below specified levels. Subsequently, it was found that even specifying all-India levels did not achieve the desired results. Though the overall stipulated levels were adhered to, bank advances in the surplus states tended to be large in relation to the output and marketable surplus. This facilitated the build-up of inventories. On the other hand, in deficit states where advances were brought down more than proportionately, traders were unable to hold adequate stocks. This aggravated the price situation in those states. To guard against this, the directives issued since December 1957 laid down specified levels for advances in surplus states along with overall levels for the country as a whole. In 1959, when State Governments introduced limited procurement programmes, the ceiling limits in those states were fixed with due regard to the changes

* According to Indian terminology, there are two types of banks—Scheduled and non-Scheduled. The former, numbering 91 in December 1957, are comparatively large-sized banks which have to satisfy certain minimum conditions regarding the paid-up capital and reserves when their names are included in a Schedule under the Reserve Bank Act. They have to maintain minimum balances, which may be varied, with the Reserve Bank from which they are entitled to borrow (or rediscount) against approved securities. Though their number is small—the non-scheduled banks number 318—they hold nearly 94 per cent of the total deposits of all banks, while their assets form about 93.5 per cent of the total assets of the banks. Though under the Banking Companies Act, selective credit control can be enforced over non-scheduled banks too, that has not been done in view of their relative insignificance.

in the stocks with traders as a result of such procurement programmes*. The overall levels were fixed taking into account the level of production, estimated marketable surplus and the necessary finance. In cases where production was larger than in the previous year a higher overall limit was allowed. The 110 percent level in relation to the previous year fixed for advances against sugar in the directive of June 29, 1957 may be cited as a case in point.

There is enough evidence to show that the Reserve Bank kept a vigilant watch over prices and made either a relaxation or a tightening of its selective control measures according as the situation called for. Thus, in 1960, in view of a comfortable supply position of sugar, prospects of a good sugar-cane crop for the current crop year and stability in sugar prices, the Bank relaxed, on December 9, 1960, the margin requirement in respect of advances against sugar, from 45 percent to 25 percent. Subsequently, in view of the significant rise in sugar output in the 1960-61 season and the sharp rise in stocks with mills, the margin requirement was completely withdrawn on April 21, 1961.

At the same time, the Bank was equally prompt in restricting advances against raw jute and jute goods. In the latter half of 1960, there was a sharp rise in the prices of jute goods as well as raw jute. Over the year ended November 1960, prices of raw jute and jute goods had risen by 72 percent and 54 percent respectively.

At the same time, advances against raw jute rose from Rs. 11 crores on October 28, 1960 to Rs. 13 crores on November 11, 1960, showing an increase of 31 percent above the level a year before. Similarly, between August, 1960 and November, 1960, advances against jute goods had increased from Rs. 20 crores to Rs. 26 crores, being 77 percent higher than the level a year before. In view of this, the Reserve Bank issued on December 12, 1960 a directive requiring (1) a minimum margin of 25 percent in respect of advances to jute mills and of 40 percent to others on the value of the stocks of raw jute ; (2) a minimum margin of 40

* Separate limits for Orissa and Madras in respect of paddy and rice were abolished by a directive dated Jan. 16, 1960, on the creation of larger food zones by the Central Government. With the improvement in the supply position of wheat, separate limits for the Punjab, Delhi, Himachal Pradesh, Jammu and Kashmir were abolished by a directive dated August 20, 1960.

percent in respect of advances against the security of jute goods and (3) a ceiling limit in each two-month period commencing from January 1961, not exceeding 130 percent of the average aggregate level of advances against jute goods in the corresponding two-month period of 1960. By subsequent amendments (dated February 24, 1961 and April 24, 1961), the margin requirement in respect of advances against jute goods* was relaxed from 40 per cent to 25 percent in favour of established shippers provided they produced documents in support of the spot purchase of jute goods by them and the bank concerned followed up each purchase until it resulted in export documentary bills.

Another important feature of the control technique was the care taken to see that the production and movement of commodities remained unaffected. The main purpose being to restrict credit to traders for financing excess inventories, all the directives exempted documentary bills covering movement of commodities. Moreover, the directives relating to cotton textiles and sugar exempted advances to mills, while the directive regarding groundnuts exempted from the higher margin requirements advances to exporters and vanaspati manufacturers. Advances to roller flour mills against wheat were exempted from the provisions of the directives issued since December, 1957. Similarly, although the December 1957 directive required banks to reduce from January 1958 advances against paddy and rice to 75 percent of the average of advances for the corresponding month in the preceding three years, they were requested to give preference to credit needs of rice mills within the overall limit.

The directives also contained concessions in respect of advances to specially favoured lines, such as, advances to co-operative processing and marketing societies, advances against warehouse receipts issued by Central and State Warehousing Corporations as well as advances by new offices of banks. Banks were allowed to make small advances of up to Rs. 50,000 within the overall credit limits and thus made possible the entry of new parties into the trade. Thus, while the technique of selective credit control was simple at the beginning, it became more complex with

* The restrictions regarding the maintenance of minimum margins in respect of advances against jute goods were withdrawn by a directive dated June 23, 1961.

subsequent refinements. The controls were operated with flexibility and awareness of changing conditions and special needs.

Implementation

What has been the impact of selective credit control? The effectiveness of this method of control is to be judged from two standpoints:—Whether the directives could be enforced expeditiously—an extremely technical objective; and secondly, how far the method adopted actually prevented the speculative rise in prices—the more important objective of this method of control. As already stated, the first directive issued in May, 1956, required all the scheduled banks, first, to raise all existing margins in respect of advances against rice and paddy by 10 percent; secondly, not to increase any existing credit limit or to grant fresh credit limit in excess of Rs. 50,000 to any person or firm. This was combined with a request to banks to reduce the aggregate of such advances to sums not exceeding 25 percent above the amount granted in the corresponding week of 1955. To examine the purely technical aspect, mentioned above, the data relating to bank advances against rice and paddy have been presented in the following table:

TABLE 1
BANK ADVANCES AGAINST RICE AND PADDY
(In crores of rupees)

	1956	April	May	June	July	August	Sept.	Oct.
1956								
Last week of the month	26.30	22.38	15.52	11.69	7.49	5.38	4.34	
1955								
Monthly figures	..	11.25	10.81	10.21	7.74	5.76	4.20	3.84

It will be seen from the table that the volume of bank advances declined continuously from Rs. 22.38 crores in May, 1956, to Rs. 7.49 crores in August, 1956, i.e. by 66.5 percent as compared to 46.7 percent during the same period of 1955. It may, however be pointed out here that the volume of such advances had already started to decline from its peak on April 27, 1956 and by the end of May, it had already been reduced by about 15 percent. But despite this rate of decline, the total of such advances against

rice and paddy was higher than that in the same period of the preceding year by 52.0 percent in June 1956, 52.3 percent in July, 30.0 percent in August and 30.5 percent in September. The 25 percent limit prescribed in the May 1956 directive was reached only in October. The volume of bank advances in these months enabled the borrowers to hold larger stocks of foodgrains even after making allowance for higher prices of rice and paddy than in the corresponding months of 1955. It rose again to 36.2 percent in November*. So, the opinion expressed in the annual report of the Board of Directors for 1955-56 that "the banking system co-operated fully in carrying out the specific terms of the directive"² may be technically correct. But they had not complied with the request of the Reserve Bank to bring down their advances to the prescribed limits.

There is also some evidence that borrowers were able to evade the terms of the directive by borrowing from the banks on some other accounts. Thus, one may point out that while the advances against rice and paddy declined, those against shares and debentures of joint-stock companies (excluding the amount granted to brokers and dealers) increased from Rs. 38.42 crores on May 25 to Rs. 43.80 crores on June 15 and further to Rs. 44.98 crores on June 29. In previous years the amount of such loans had declined between the end of March to that of June. Apart from this, another important point revealed from a careful examination of the data relating to bank advances is that between March and June, 1956, advances granted to commerce under the omnibus heading, "others", increased from Rs. 35.2 crores to Rs. 41.2 crores, while these had consistently shown declines in the previous four years. Further, while the volume of advances against principal types of securities for which fortnightly returns have to be submitted to the Reserve Bank formed 73.0 percent of the total advances of these banks on May 11, 1956, this ratio declined to 70.8 percent in June, 1956. On the other hand, the proportion of those advances in respect of which no fortnightly statements have to be submitted rose from 27 percent in May to 29.2 percent in June. Thus while bank advances against rice and paddy recorded a decline more than in proportion to the previous year's trend,

* The directive was withdrawn on Nov. 14, 1956.

² *Reserve Bank Bulletin*, August, 1956, p. 800.

those against certain other heads showed an abnormal rate of increase during the same period. There was also no visible impact on the prices of rice and paddy, which continued to rise from 93 in May to 100 in August, 1956, i.e., by 7.5 percent. Nor could the impact of this control order on the growth in the total volume of bank advances be regarded as significant. It declined from Rs. 769.04 crores on May 25, 1956 to Rs. 756.89 crores on June 29, and to Rs. 734.97 crores on August 31, i.e., a reduction of only Rs. 34 crores, which was definitely smaller than the normal slack season decline.

The volume of bank advances against other foodgrains like wheat, gram, jowar, pulses etc., also began to increase from Rs. 10.15 crores on April 27, 1956 to Rs. 15.00 crores on May 25 and to Rs. 20.62 crores on June 29, the highest amount during the previous five years. This increase took place at a time when the output of most of these commodities declined and their prices rose sharply. Although such advances declined thereafter in accordance with the seasonal trend, they were higher by about 50 percent over the level of July 1955. On September 13 the Reserve Bank issued another directive which required banks not only to raise margins on existing credit limits by 10 percent but also to maintain the higher margins on all such future advances. It also requested banks to reduce their aggregate advances against these commodities to the level, which, by the end of October, 1956, was not to be higher than that of the corresponding week in the previous year. The following table will illustrate the impact of this directive.

TABLE 2
BANK ADVANCES AGAINST WHEAT AND OTHER FOODGRAINS
(In crores of rupees)

		July	August	Sept.	Oct.	Nov.	Dec.
1956*	..	18.88	16.80	12.68	9.35	8.8	9.17
1955	..	12.91	11.22	8.56	6.82	6.65	8.86

There was no doubt that the decline in bank advances against other foodgrains was more rapid after the issue of the directive on September 13, 1956, than could be explained by the

* The data for 1956 relate to the last fortnight of each month while those for 1955 relate to monthly figures.

normal seasonal trend. But the total of such advances in October 1956 was higher by 37 percent over the level of October 1955, though the Reserve Bank requested the banks to reduce them to a level not substantially above that of the previous October. A similar directive was issued on September 14 regarding the grant of advances against cotton textiles (including yarn). Such advances had increased from Rs. 58.25 crores on April 13, 1956 to Rs. 61.14 crores on July 27 and to Rs. 63.96 crores on September 14, the date of issue of this directive. It also asked the banks to raise the margin on all such loans by 10 percent. The Reserve Bank, however, made no request to banks to bring down such advances to any particular level. The volume of such advances continued rising even after this directive, and increased from Rs. 66.73 crores on September 28 to Rs. 71.98 crores on November 30 and finally to Rs. 81.12 crores on December 28. Viewed as an attempt to reduce the volume of such advances, this attempt does not seem to have met with any success.

The withdrawal of restrictions in the grant of bank advances against rice and paddy in November, 1956 proved to be a hasty step, as subsequent events showed. This was followed immediately by a rise in the volume of bank advances against rice and paddy from Rs. 5.09 crores on November 15, 1956 to Rs. 9.61 crores on December 28, 1956 and Rs. 16.13 crores on January 25, 1957. So the Reserve Bank was forced to re-impose control over this particular use of bank credit. This new directive issued on February 9, 1957, asked banks to raise the margins against such advances by 10 percent with regard to all existing and future transactions and also laid down a new rule that the minimum margin in all such cases must be at least 35 percent of the value of the commodities pledged or hypothecated. A request was also made to banks to bring down, by the 15th March, the total of such advances to not more than 75 percent of the level obtaining in the corresponding week of 1956. In view of the fact that the level of such advances in March 1956 was already higher than that of a year earlier by more than 110 percent, this restriction may be regarded as very liberal. But the result of even so liberal a directive was not as desired. This will be clear from the table below :

TABLE 3

BANK ADVANCES AGAINST RICE AND PADDY
(In crores of rupees)

		March	April	May	June
1956	actuals	24.71	26.80	22.38	15.52
75%	of 1956	18.53	19.73	16.79	11.64
1957	..	22.79	22.12	21.48	16.89
1955	..	11.64	11.25	10.81	10.21

The table shows that whatever the degree of pressure exerted by higher margin requirements, banks failed to bring down their advances to the levels requested by the Reserve Bank*. On June 7, 1957, the Reserve Bank issued a fresh directive for tightening the system of control. The margin against all loans against foodgrains was raised by another 5 percent i.e., by 15 percent with a minimum of 40 percent and for the first time banks were directed, instead of being simply requested, to reduce their advances to 66.7 percent in the case of rice and paddy and 75 percent in the case of other foodgrains of the levels prevailing in the same period of 1956. Movements in the volume of advances against foodgrains in subsequent months as against their prescribed levels are given in the table below :

TABLE 4

BANK ADVANCES AGAINST FOODGRAINS
(In crores of rupees)

	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Prescribed levels	25.82	21.96	17.60	13.4	9.90	10.90	13.29
1957	37.69	27.44	18.86	12.81	14.01	14.30	14.73
1955	21.76	20.65	16.98	12.76	10.66	11.31	16.17

The directive was issued on June 7 and bank advances against foodgrains were reduced below the prescribed level only in September, i.e., after a lapse of more than 3½ months. There was no doubt that some attempt was made by the banks to reduce the total of such advances to the prescribed levels. Thus, between June 14 and the end of September, bank advances against foodgrains declined by about 68 percent in 1957 while the rate of decline was 61 percent in 1956 and 51 percent in 1955.

* The total of such advances declined by only 25% between March and June 1967 as against 37.2% in 1956.

Bank advances against foodgrains, however, increased above the prescribed levels in the subsequent three months. This was clearly a breach of the provisions of the June directive. One may excuse this as being of a purely technical nature, considering that the volume of such advances in these months was still as low as 40 percent of the average of those advances in May, June and July of this year. The amount of such advances in December 1957 was lower than the average of the last four years in the same month. But the rising trend of such advances after September is clearly an unsatisfactory feature. The average level of bank advances for the second half of 1957 was Rs. 16.90 crores as against Rs. 18.44 crores in 1956. Banks were asked in 1957 to raise the margin in respect of their advances against foodgrains by 10 percent and to maintain a minimum margin of at least 40 percent. Assuming that they just complied with the provisions of the directive, they maintained a minimum overall margin of 30 percent in 1956 and 40 percent in 1957. Bank advances of Rs. 18.44 crores were granted against the hypothecation of stocks of foodgrains worth Rs. 26.40 crores on the 30 percent margin basis. In 1957, bank advances of Rs. 16.90 crores meant the hypothecation of stocks worth Rs. 28.17 crores. Thus the Reserve Bank's contention that in the second half of 1957 "the level of stocks against which bank advances were secured was lower than in the previous year³ is not borne out by facts.

Simultaneously with the directive issued on bank advances against foodgrains, the Reserve Bank issued on June 29 a second directive dealing with sugar, another food article. The volume of bank advances against sugar reached a rather high level and its price also recorded a disproportionate increase. Banks were, as usual, required to raise the margin on all such advances by 10 percent with a minimum of 35 percent.

The directives on bank advances against foodgrains had undoubtedly put some pressure on banks and brought about a substantial decline in the volume of bank advances against foodgrains. Bank advances against rice and paddy round the level of Rs. 4 crores at which they remained in the months of September and October 1957, cannot be considered excessive. But a detailed

³ *Trend and Progress of Banking*, 1957, p. 4.

examination of the data will reveal the interesting information that while such advances against rice and paddy tended to decline in the main consuming areas, they remained at comparatively high figures in the main producing centres. Between May and October 1957, bank advances against rice and paddy declined by 80.4 percent. But these declined by only 76 percent in Andhra Pradesh, 63.5 percent in U.P., 77 percent in Madras and 78 percent in Madhya Pradesh, while the rate of decline was 95.4 percent in Assam, 91.7 percent in Bihar and 90 percent in West Bengal. From this it is clear that some banks were still granting a disproportionately heavy amount of advances against rice and paddy in the main producing states of Andhra Pradesh, Madras and Madhya Pradesh, while substantially reducing the same in the main consuming states. Data of overall decline in such advances, therefore, concealed this important trend, which had some impact on rice prices in the producing centres. So the Reserve Bank came out with another directive on December 11, 1957 relating to Bank advances against foodgrains. This directive had several new features. In addition to requiring banks to maintain a minimum margin of 40 percent in the case of all such advances and to restrict the sanction of new credit limits to individual parties to not more than Rs. 50,000, it directed banks to maintain in each month from January 1958 an average aggregate level of their advances to an amount not exceeding 75 percent in the case of rice and paddy and 80 percent in the case of wheat and other foodgrains, of the average of the corresponding months of 1955, 1956 and 1957, i.e., previous three years instead of one year. Moreover, banks having branches or offices in Andhra Pradesh and Madhya Pradesh were required to maintain their advances against rice and paddy for each month to a level not exceeding 60 percent of the amount in the corresponding months of 1957, subject to the overall limit of 75 percent. Advances granted by branches or offices opened after January 1958 were exempt from the overall limit, provided the ratio of foodgrains advances to total advances of these offices or branches did not exceed the relevant ratio of all other offices of the bank, subject to a maximum of 10 percent.

This directive marks an important stage in the evolution of the technique of selective credit control. From mere requests asking banks to refrain from the grant of excessive credit for speculative purposes, the technique had been developed in the direction of

fixing and when, necessary, raising the margins on particular types of advances. This has been combined with the fixation of ceilings as at each stage, the Reserve Bank tried to fix a minimum in the case of individual credit transaction (generally Rs. 50,000), and an overall maximum for all such transactions on the basis of a certain ratio of the total of such advances in the previous year or previous 3 years. Further, the technique had been sharpened by making it discriminatory between different regions or even between different branches of a bank. The last two innovations have considerably added to the flexibility of the technique. The Indian experiment, it may be pointed out here, is different from the Federal Reserve Board technique in at least three respects. The use of higher margin requirements has at every stage been combined with quantitative limitations. Secondly, the Indian technique is discriminatory between banks in different regions or branches of the same bank while the Federal Reserve Board's use of this method has been entirely non-discriminatory. Thirdly, the coverage of the Federal Reserve technique is much wider than that of the powers entrusted to the Reserve Bank of India. The powers of the latter were applied only to the scheduled banks registered under the Banking Act.

The analysis in the foregoing paragraphs of the various directives has made it clear that compliance in the beginning was not all that could be desired. This may be explained, among others, by the difficulty of reducing the accommodation granted to so many customers spread over a large country. Banks may call upon their customers to maintain higher margins on their credit transactions. But they are generally reluctant to recall the loans before they fall due. To honour the existing commitments is an obligation of the banks and if these were honoured subject to the requirement regarding higher margins, no reduction in the total volume of such advances would follow. Fixation of higher margins would no doubt put some pressure on existing or future borrowers, and the weaker among them might be forced to reduce their commitments. To that extent the directives would bring about some reduction in bank advances. But the extent of such reduction would depend on the availability or non-availability of additional funds from the banks or other financial institutions. There is, further, the difficulty of refusing the requests for accommodation from valued and old customers. All these go to explain

the failure of the banking system to reduce its advances to the limits prescribed in the directives. There has also been, as the Governor of the Reserve Bank stated, "a certain looseness in the effectiveness of managerial control over a sprawling net-work of branches"¹.

Even in those cases where some compliance with the provisions of the directives was found, this generally took place with a considerable time-lag. This may be explained by the fact that banks, particularly the larger banks, did not have suitable machinery for quickly enforcing the provisions of the directives in their far-flung branches. Secondly, there was the difficulty of co-ordinating the operations of so many branch managers many of whom might not be fully conscious of the larger implications of the policy of control. Moreover, nominal compliance with directives was found to conceal, in a number of cases, indirect evasions. A bank, having branches in both producing and consuming centres, was found to grant large advances to traders in the main producing centres. The innovations in the December 1957 directive were meant to prevent such evasions.

Whatever may have been the impact of selective control in the beginning, in the subsequent months and years, control method may be said to have achieved its purpose. As the Reserve Bank gained more and more experience, changes and modifications were introduced in the mechanism to plug the former loopholes and deal with the new situations effectively. Thus, in the directive on groundnuts issued on February 9, 1959, and on oil-seed on December 11, 1959, banks were asked not to allow to parties affected by the directives credit facilities through clean advances etc. which would have defeated the purpose of control. The *raison d'être* of the issue of the directive on clean advances on March 11, 1960 was to prevent circumvention of selective controls through this avenue. Though not quickly, but after some lapse of time, the issue of a directive was usually followed by a reduction in bank advances against the controlled commodity*.

¹ *Reserve Bank Bulletin*, November, 1957. This is also the experience with selective credit control in New Zealand. See C.G.F. Simkin—*The Banker*, August, 1956.

* Statements of advances against paddy and rice, wheat and other food-grains, are appended to this chapter to facilitate appreciation of the working of the credit controls. The tables do not however bear out fully the extent of implementation of the directives as the figures are inclusive of various exempted categories such as demand documentary bills, advances to State Governments for financing their procurement programmes, advances against

Thus, advances of scheduled banks against paddy and rice which amounted to Rs. 26 crores in April 1956, being 135 percent higher than a year earlier, declined after the issue of the directive in May 1956 and stood at only Rs. 4 crores in October 1956, i.e., the same level as in October, 1955. Similarly, after the June 1957 directive, advances against foodgrains contracted steeply and in September 1957 amounted to only Rs. 13 crores as against Rs. 40 crores in May 1957 and Rs. 18 crores in September 1956. The reductions effected were steeper than in the corresponding periods of the previous years and could, therefore, be attributed in large part to the operation of controls. Subsequent experience was equally satisfactory. Total advances against foodgrains generally reach their peak in June and the following table shows the efficacy of the directives in reducing the level of advances.

TABLE 5

	1956	1957	1958	1959	1960
Maximum in June ..	38.5	40.1	25.6	30.0	28.09

Only in the case of "other foodgrains", did the banks exceed the permitted levels through most of 1959, the magnitude of the excess becoming more pronounced after June. Thus at their peak in June the advances adjusted for exempted categories were Rs. 75 lakhs above the permitted level². In the following two months the excess was as much as Rs. 2 crores though subsequently the trend was downward. The excess may be explained by the substantial rise in outturn in the 1958-59 season over that of the previous year which was comparatively a poor crop year. There was, therefore, the need for making good the deficiency in stocks which had run low. Bank advances against "other foodgrains" were generally maintained within permitted levels in the first half of 1960. It may also be pointed out here that the full impact of a control measure is to be discerned only with reference to banks' new business, because adjustment in respect of old advances takes a long time. But separate data of new business are not available.

Moreover, taking into account the difficulties associated with the under-developed nature of the Indian money market and the

wheat to roller flour mills, advances against warehouse receipts issued by Central and State warehousing Corporations etc. Nevertheless, it may be said that by and large, banks maintained their advances against paddy and rice and wheat within the levels prescribed.

² *Trend and Progress of Banking, 1959.*

fact that the experiment with selective credit control was made for the first time in India, the Reserve Bank's performance in this respect may be said to have been commendable, especially when there were no lessons to draw from the experience of any other central bank of an under-developed country.

Appraisal :

The Reserve Bank carried out the experiment with the selective credit-cum-portfolio ceilings control during a period of more or less continuous inflationary pressure generated by large-scale government expenditure. The main objective was of course a limited one. So long as large-scale development expenditure is incurred and the increase in the supply of foodgrains becomes short of actual requirements, the trend towards rising food prices cannot be prevented. Speculative withholding of stocks of foodgrains would, however, accentuate this rising trend of food prices. It was only this latter danger which the Reserve Bank sought to curb through selective credit control operations, in so far as bank finance was being utilised in such transactions. No doubt the volume of bank advances against foodgrains which forms less than 4 percent of the total volume of bank advances, is insignificant compared to the volume of funds invested in financing the movement and storage of foodgrains in the country. Hence one may argue that any variations in the amount of bank advances against foodgrains are not likely to influence, in any significant manner, their supplies in the market and their prices. But additional bank credit may have led to the withholding of the marginal supplies from the market, and in view of the inelastic nature of the demand, may have accentuated the rising trend of food prices. By asking for a reduction in bank advances against foodgrains selective credit control may force the marginal supply back to the market and so prevent a further rise in food prices or even bring down food prices. Bank finance may have also enabled dealers in the more important urban centres and the rice mills to withhold supplies from the markets with resulting increase in food prices in these markets. These often acted as price leaders in the foodgrains market. Because of the lack of homogeneity in the price structure, bank finance may have influenced food prices to a larger extent than warranted by its actual amount.

The successful implementation of this method of control may also influence food prices in another way. Rightly or wrongly there was a widespread feeling that traders and other speculators had started hoarding large quantities of foodgrains and this was believed to be an important factor in pushing up prices. There was this danger that this belief might have led to anticipatory hoarding by consumers, and if that took place, there would have been a sort of hectic demand for foodgrains. A wise and energetic use of selective credit control countered the growth of such a belief and so by preventing hoarding by consumers, proved actually to be an important factor in checking the rise in foodprices. This aspect of selective credit control is not a negligible factor in the rising market.

Although compliance with all the provisions of the directives, especially those relating to the fixation of portfolio ceilings on such advances, was not always obtained as desired, these control measures might have affected the position in other ways. The fixation of higher margins on such advances would drive the existing borrowers to find additional funds from some other source or sources, if they want to hold on to the same stock of goods. If additional resources are not readily available, they would have to reduce their stocks. The result would be that they would be forced to unload a part of their stocks while future borrowers would cut down their plans for inventory building. This would have a salutary effect on the foodgrains market, tending to eliminate at least a portion of the speculative rise in prices. Obviously, the question is : to what extent could borrowers secure additional funds from the banks on other accounts or from other sources ? It has already been pointed out that increases in the volume of bank advances against certain other types of securities took place simultaneously with the decline in bank advances against foodgrains. If borrowers could secure accommodation from the banks against other securities, there would naturally be no reduction in speculative holding of foodgrains. The success of selective credit control measures would, therefore, depend on the extent to which existing or potential borrowers could be prevented from borrowing from the banks on other accounts or against other securities.

Besides borrowing from banks and then utilising the funds to finance speculative holding of foodgrains, there are additional sources to which the fringe of unsatisfied borrowers might turn :—

the non-scheduled banks and the indigenous bankers. (An examination of the data on the advances of the non-scheduled banks does not reveal any abnormal movement in such advances during the periods covered by the directives. Thus borrowers did not turn to the non-scheduled banks when refused accommodation by the scheduled banks.) It is well known that the indigenous bankers provide the major part of their funds in financing the movement and storage of agricultural crops including foodgrains. Unfortunately no information is available with regard to their total resources or their investments in stocks of foodgrains. All that is known about them is that they finance their business with their own resources and go to banks to meet marginal requirements in seasons of heavy demand. Their charges are usually higher than those of the scheduled banks. The refusal of the scheduled banks to grant more loans against foodgrains or their insistence on higher margins may force the speculative holders to approach the indigenous bankers. Then the result may simply be a rise in money rates, and not smaller availability. If expectations regarding the rise in prices are very high, the necessity to pay higher rates would not prove to be much of a deterrent to speculative holding of foodgrains. Because of the total absence of any data regarding the transactions of this important group of lenders it is not possible to examine the extent to which any shift occurred from the scheduled banks to the indigenous sector. But the existence of such an alternative source of supply of funds and the consequent fear of losing valuable customers might have had the effect of stiffening the resistance of the scheduled banks to the pressure of these directives.

While a shift to indigenous bankers cannot be prevented under present conditions, borrowing from the banks on other accounts would have to be restricted to make selective control operations fully effective. This calls for limiting the growth in the total volume of bank advances simultaneously with the adoption of the present selective credit control methods. If this is not done, there will be considerable seepage of funds from the unrestricted sector to the restricted sector. So, to be really effective against speculative withholding of goods from the market, selective control measures should be combined with an attempt to limit the growth in bank advances and even to bring about a simultaneous reduction in the total volume of bank advances. It may be pointed out

here that the success which attended the June Directive of 1957 against foodgrains and sugar was due to a large extent to the attempt made simultaneously by the Reserve Bank to bring down the total bank advances to Rs. 800 crores. The reason for the shift in emphasis to selective control as against general quantitative controls is to be found in the shortcomings felt in the latter's working. Quantitative limitations like higher bank rate discriminate against legitimate uses of bank credit. As Prof. Smithies has said, general credit restraint curbs investment more than consumption, while in many cases, consumption should be restrained more than investment or investment should be encouraged while restraining consumption.⁶ Selective control can of course be exercised in such a way as to restrain particular types of investment or consumption, while leaving others untouched. But more often than not, curtailment of expenditure in particular channels is followed by an increase in investment in other directions. For, selective control operations, instead of reducing the total volume of bank credit, usually serve only to divert the flow of bank credit to other channels. The difficulties experienced in the working of this method of control under Indian conditions have already been examined and there is no doubt that most of the difficulties can be removed through an energetic use of this method of control. But the question is,—even if all the administrative loopholes are closed, can the methods of selective control alone be made fully effective?

These methods would be most effective only when the aggregate monetary pressure in the economy is at its normal level but there may be one or a few sensitive spots attracting abnormally disproportionate amount of money or bank credit. If enough counter-pressure is put on these sensitive spots, these abnormal accretions of money may flow back into appropriate channels. In such a situation, not a system of general credit restraints but one of selective control would be the proper remedy. But if the general monetary pressure in the circulatory system rises above the normal or appropriate level, i.e., the level that would ensure the optimum money supply to carry the economy along its warranted rate of growth, certain parts may also show evident signs of abnormal pressure to a much greater extent than others. Under these conditions, the application of counter-pressures

⁶ *Review of Economics & Statistics*, August, 1957, p. 281.

through purely selective credit control would not only meet with increasing resistance but might serve, if successful, only to divert the growing pressure to some other points. The proper remedy for such a situation is to apply general credit restraints in order to bring down monetary pressure to its appropriate level. If, however, it is found that even after the general credit restraints have been put into use, there are certain pressure-points left that cannot be tackled by purely quantitative method, it may be useful to reinforce such method with selective credit control operations.

Mounting development expenditure financed by the creation of new money coupled with inelasticities of supply of foodgrains, provided, under Indian conditions, a great stimulus to speculative and precautionary motives. These led businessmen to exploit the situation by shifting from cash into non-monetary assets and then borrowing to carry such assets in anticipation of market conditions. This seems to be borne out by the data relating to company finance published in the Reserve Bank Bulletin.⁷ An examination of such data reveals a shift from cash, bank balances and government securities which declined in 1956 by 18.4 percent, while inventory accumulation rose by more than 29 percent, over the levels prevailing in 1955. As the Indian experience shows, it may not be an easy task to restrain the operation of these speculative and precautionary motives through purely selective credit control methods unaided by quantitative limitations.*

Thus selective credit control measures have only a limited role to play. They cannot always be made effective in the absence of quantitative methods of control, to say nothing of their being substitutes for the latter. They will give the best possible results only when combined with a vigorous drive to restrict the total volume of bank advances. But even with such a combination, they are seldom quick in action. There would usually be a considerable time-lag before they can be made fully effective. The larger the number of sectors to be covered by this method of control, the greater are likely to be the administrative difficulties.

⁷ *Reserve Bank Bulletin*, June, 1958.

* In March 1960, the Reserve Bank resorted to the instrument of variable reserve requirements for the first time, imposing 25 percent of additional deposits accruing to banks after March 11, 1960.

Appendix I to Chapter VII

TABLE 1
OUTSTANDING ADVANCES OF SCHEDULED BANKS AGAINST PADDY AND RICE
(Rupees in Lakhs)

As on the last Friday of	1956	1957	1958	1959	1960
January ..	14,20	16,13	8,76	8,15	11,33
February ..	19,43	23,18	11,11	10,83	14,25
March ..	24,71	22,79	12,19	12,47	14,86
April ..	26,30	22,12	13,96	11,37	14,36
May ..	22,38	21,48	13,31	10,93	14,20
June ..	15,52	16,89	9,44	11,49	13,11
July ..	11,69	11,09	7,13	9,89	10,40
August ..	7,49	6,44	4,48	7,41	8,32
September ..	5,38	3,95	3,38	5,37	5,97
October ..	4,34	4,21	3,46	5,26	5,73
November ..	6,35	4,86	4,40	6,62	5,76
December ..	9,61	6,18	5,40	7,82	7,30

TABLE 2
OUTSTANDING ADVANCES OF SCHEDULED BANKS AGAINST WHEAT
(Rupees in Lakhs)

As on the last Friday of	1956	1957	1958	1959	1960
January ..	—	2,01	2,09	1,03	1,10
February ..	—	1,35	1,66	2,34	1,11
March ..	—	1,13	1,56	1,64	1,57
April ..	—	1,43	1,58	1,44	2,09
May ..	—	4,41	2,92	1,89	3,01
June ..	—	6,05	4,36	2,93	3,66
July ..	—	4,82	3,90	2,72	3,02
August ..	—	3,72	2,90	2,57	2,72
September ..	4,22	2,75	2,24	1,48	2,47
October ..	2,88	2,87	1,27	99	3,70
November ..	2,55	2,44	82	1,08	4,08
December ..	2,45	2,19	73	1,08	2,38

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TABLE 3

OUTSTANDING ADVANCES OF SCHEDULED BANKS AGAINST OTHER FOODGRAINS
(Rupees in Lakhs)

As on the last Friday of	1956	1957	1958	1959	1960
January	.. —	6,11	5,53	5,91	6,07
February	.. —	5,99	4,70	5,50	6,61
March	.. —	5,88	5,89	6,66	5,79
April	.. —	8,20	7,62	7,15	9,03
May	.. —	14,39	10,00	15,25	10,59
June	.. —	14,75	10,94	15,60	12,12
July	.. —	11,53	9,11	12,90	11,63
August	.. —	8,70	6,48	9,52	9,26
September	.. 8,46	6,11	5,04	7,35	7,98
October	.. 6,47	6,93	5,73	6,43	7,03
November	.. 6,33	7,00	4,71	5,90	6,47
December	.. 6,74	6,36	4,46	5,63	5,85

TABLE 4

OUTSTANDING ADVANCES OF SCHEDULED BANKS AGAINST ALL FOODGRAINS
(Rupees in Lakhs)

As on the last Friday of	1956	1957	1958	1959	1960
January	.. 22,31	24,25	16,38	15,09	18,50
February	.. 26,51	30,52	17,47	18,67	21,97
March	.. 32,68	29,80	19,64	20,77	22,22
April	.. 36,45	31,75	23,16	19,96	25,48
May	.. 37,38	40,28	26,23	28,07	27,76
June	.. 36,14	37,69	24,74	30,02	28,90
July	.. 30,57	27,44	20,14	25,51	25,05
August	.. 24,29	18,86	13,86	19,50	20,30
September	.. 18,06	12,81	10,66	14,20	16,42
October	.. 13,69	14,01	10,46	12,86	16,46
November	.. 15,23	14,30	9,93	13,60	16,31
December	.. 18,80	14,73	10,59	14,53	15,53

Appendix II to Chapter VII

PROVISIONS OF DIRECTIVES ISSUED TO SCHEDULED
BANKS BY THE RESERVE BANK IN RESPECT OF
SELECTIVE CREDIT CONTROLS

*Margin, **Ceiling on Advances, ***Exemptions.

I. May 17, 1956, Paddy and Rice.

*Increase in the margin against existing credit limits by not less than 10 percent of the value of stocks.

** (a) No mandatory provisions, but banks were requested to bring the aggregate of advances to a level which at any time was not more than 25 percent above that of the corresponding date of last year.

(b) Banks were prohibited from increasing any existing credit limit and from granting any fresh credit limit in excess of Rs. 50,000 to any single party.

*** Demand Documentary Bills representing internal movements of crops were exempted (July 11, 1956).

On October 18, 1956, by the issue of a directive banks were allowed to raise existing credit limits up to Rs. 50,000 in cases where the credit limits were below Rs. 50,000. They were also asked to increase margins on fresh credit limits by 10 percent over the usual margins. The whole directive was withdrawn on November 14, 1956.

II. September 13, 1956. Wheat and 'Other' Foodgrains i.e. (jowar, bajra, maize, barley, ragi, gram, all other grains and pulses).

*Increase in the margin against existing credit limits by not less than 10 percent of the value of the stock of commodities; maintenance of a margin of 10 percent above the usual margins in respect of fresh credit limits.

** (a) No mandatory provisions, but banks were requested to bring down advances to a level which did not remain substantially higher than that in the corresponding week of the previous year.

(b) Banks were prohibited from increasing the existing credit limits to amounts beyond Rs. 50,000 and from granting fresh credit limits in excess of Rs. 50,000 to any single party.

***Demand Documentary Bills were exempted.

III. September 13, 1956, Cotton textiles including yarn.

*Increase in the margin against existing credit limits by not less than 10 percent of the value of the stock of commodities ; maintenance of a margin of 10 percent above the usual margins in respect of fresh credit limits.

**Exemptions were granted in case of (1) advances to cotton textile mills, (2) advances against cotton textiles including yarn intended for export, (3) advances by way of purchase of Demand Documentary Bills, (4) advances against the security of handloom cotton cloth (circular dated October 4, 1956).

The directive was withdrawn on February 1, 1957.

IV. February 9, 1957, Paddy and Rice.

*Increase in the existing margin on credit limits granted before the date of the directive by not less than 10 percent with a minimum of 35 percent of the value of the commodities ; in respect of fresh credit limits margins were to be maintained at 10 percent above usual margin or 35 percent whichever was higher.

**No mandatory provisions, but banks were requested to maintain a level of aggregate advances, which from March 15, 1957 and in every week thereafter, was not more than 75 percent of the level obtaining in the corresponding week of the previous year.

***Demand Documentary Bills were exempted.

V. June 7, 1957, All Foodgrains.

*Increase in the existing margin on credit limits granted before the date of the directive by 5 percent subject to a minimum of 40 percent ; minimum margin of 40 percent required against all fresh credit limits.

** (a) Mandatory provision regulating aggregate level of advances from July 12, 1957 against paddy and rice at not more than $66\frac{2}{3}$ percent and against other foodgrains at not more than 75 percent of the level obtaining in the corresponding week of the previous year.

(b) Banks were prohibited from sanctioning new limits and/or increasing existing credit limits in excess of Rs. 50,000.

***Demand Documentary Bills were exempted.

This directive superseded the directives of September 13, 1956 and February 9, 1957.

VI. June 29, 1957, Sugar.

*Increase in the margin on existing credit limits by not less than 10 percent with a minimum margin of 35 percent to be kept on existing as well as fresh credit limits.

**Aggregate level of credit was to be maintained at not more than 10 percent of that obtaining in the corresponding week of previous year.

*** (1) Concerns manufacturing sugar were exempted from the margin requirement.

(2) Demand Documentary Bills drawn in connection with the movement of sugar were exempted from the directive (Directive dated July 15, 1957).

VII. December 11, 1957, All foodgrains.

*A minimum margin of 40 percent of the value of stocks.

** (a) Prescription of average aggregate limit¹ (for each month from January 1958 onwards) at 75 percent in case of paddy and rice and 80 percent in case of wheat and other foodgrains, of the average of advances outstanding on the last Friday of the corresponding month of the three preceding years.

Subject to this overall aggregate ceiling, banks were asked to maintain their average aggregate level of credit at offices or branches in Andhra Pradesh and Madhya Pradesh against paddy and rice during each month of 1958 at a level of not more than 60 percent respectively of the advances by those offices or branches outstanding as on the last Friday of the corresponding month of 1957.

(b) Prohibition of increase of any existing credit limit to an amount beyond Rs. 50,000 and of the sanctioning of fresh limits beyond this amount.

***Exemptions were granted in case of advances (1) To roller flour mills against wheat; (2) advances granted by offices of banks opened on or after January 1, 1957 provided that the proportion of foodgrain advances granted by all such offices to their total credit was the same as that in case of other offices or 10 percent whichever was less; (3) advances against pledge

¹ Average aggregate credit (limit) means the average of the outstanding advances on the 2nd and 4th Fridays when four Fridays occur in a month and the 3rd and 5th Fridays when there are five Fridays in a month.

of warehouse receipts covering foodgrains (Directive dated January 16, 1958); (4) advances up to a total of Rs. 1 lakh per office against foodgrains kept in the possession or control of the office concerned by offices opened on or after January 1, 1958 in places within a radius of 20 miles of which there was no other office of a scheduled bank (Directive dated April 1, 1958); (5) advances granted by scheduled banks to co-operative processing and marketing societies (Circular dated June 3, 1958); (6) Demand Documentary Bills.

VIII. December 11, 1957, Sugar.

*A margin of 35 percent of value of stocks in case of advances to parties other than those manufacturing sugar.

The stipulation regarding the ceiling on advances, contained in the directive dated June 29, 1957 was withdrawn.

IX. July 18, 1958. Sugar.

*A margin of not less than 45 percent on the value of stocks in case of parties (1) other than those manufacturing sugar; (2) and to parties manufacturing sugar in respect of such stocks as had left the mills or factory premises and on which excise duty had been paid.

***Demand Documentary Bills were exempted.

X. September 10, 1958. Wheat.

*The minimum margin of 40 percent as prescribed in December 11, 1957 directive.

** (a) Prescription of average aggregate level (from October 1958) at $66\frac{2}{3}$ percent of the bank's average aggregate level of advances in the corresponding month of 1957.

(b) The stipulation relating to average aggregate level was made applicable to offices operating in all States and in the State of Punjab separately.

***Exemptions as provided in the December 11, 1957 directive.

The other provisions of the December 11, 1957 circular remained unaltered.

Other foodgrains.

*The minimum margin of 40 percent as prescribed in December 11, 1957 directive.

**80 percent of the average aggregate level of credit in the corresponding month of 1957.

***Exemptions as provided in December 11, 1957 directive.
 XI. December 29, 1958. All foodgrains.

*The minimum margin of 40 percent as prescribed in December 11, 1957 directive.

** (a) Prescription of average aggregate limit (for each month from January 1959 onwards) as follows: (i) paddy and rice—permitted level of the corresponding month in 1958 (ii) wheat (iii) other foodgrains—actual level of the corresponding month in 1958.

Subject to this overall aggregate, banks were asked to maintain their advances against paddy and rice in Andhra and Madhya Pradesh during each month of 1959 within the permitted level for the corresponding month of 1958. In Punjab, banks were asked not to exceed the actual level of advances against wheat in the corresponding month of 1958.

(b) Prohibition on extension or enhancement of credit in excess of Rs. 50,000 to an individual borrower.

***Exemptions as provided in December 11, 1957 directive.

In partial modification of this directive, banks operating in Orissa were allowed to advance against paddy and rice, in addition to the permitted level in terms of this directive, three times the actual level of advances maintained by the branches or offices in Orissa in the corresponding month of 1958 provided that the additional credit was given only to licensed purchasing agents of Government. (Directive dated April 24, 1959).

XII. February 9, 1959. Groundnuts.

*A margin of not less than 45 percent of the value of stocks. Advances to Vanaspati manufacturers and exporters of groundnuts were exempted from the margin requirements.

**Banks were asked to maintain during each month from March 1959 an average aggregate level of credit not exceeding the level of credit maintained in the corresponding month of 1958 or 1957 whichever was higher.

***Demand Documentary Bills and advances against warehouse receipts were exempted.

XIII. July 10, 1959. All foodgrains.

*A minimum margin of 40 percent subject to a reduction to 25 percent against paddy and rice to purchasing agents of the Government of Orissa and against wheat to storage delivery contractors of Punjab Government.

****Banks** were asked to maintain during each month from August 1959 their average aggregate credit against the security of the relative stocks of commodities at a level not exceeding :

Paddy and Rice

(i) In respect of offices in Andhra and Madhya Pradesh, the level permitted to be maintained by such offices in the corresponding month of 1958, subject to a maximum of $33\frac{1}{3}$ percent to parties other than rice mills.

(ii) In Madras 60 percent of the average aggregate level actually maintained by offices in Madras in the corresponding month of 1958.

(iii) In Orissa specified limits were fixed for individual banks of which 80 percent was to be made available to rice mills or purchasing agents.

(iv) In other States 120 percent of the average aggregate level of credit actually maintained by offices in these states in the corresponding month of 1958.

Wheat

(i) In respect of offices, in the Punjab, Himachal Pradesh, Delhi and Jammu and Kashmir 75 percent of the average aggregate level of credit actually maintained by such offices in the corresponding month of 1958 and an additional average aggregate level equivalent to 25 percent of the actual level of credit maintained in the corresponding month of 1958 if the additional credit was to storage delivery contractors of the Government of Punjab.

(ii) In respect of offices in other States the average aggregate level of credit actually maintained by offices in these States in the corresponding month of 1958.

'Other' Foodgrains

(i) In respect of offices in Madhya Pradesh & Uttar Pradesh 75 percent of the average aggregate level of credit actually maintained by such offices in the corresponding month of 1958.

(ii) In respect of offices in Other States the average aggregate level of credit actually maintained by offices in these States in the corresponding month of 1958.

Exemptions : (1) Up to Rs. 1 lakh to offices and branches opened on or after January 1, 1958 in a 'centre without banking facilities'² provided the foodgrains against the security of which advances were made were in possession or control of the offices.

² 'A Centre without banking facilities' refers to a place within a radius of 15 miles in which there is no office of a scheduled bank.

This exemption was available up to one year of the opening of the branch or till the opening of an office of another scheduled bank whichever is longer.

(2) In respect of other offices opened on or after January 1, 1958 the limit was fixed so that the proportion of credit granted by such offices against the security of foodgrains to their total credit did not exceed three times the proportion which the credit granted by other offices of the bank bore to the total credit of those offices or 15 percent whichever was lower.

(3) Advances against warehouse receipts and to co-operative marketing and processing societies.

(4) Demand Documentary Bills drawn in connection with the movement of foodgrains.

(5) Advances against wheat to roller flour mills.

The existing prohibition against the sanction of fresh credit limits or increase in the existing limits in excess of Rs. 50,000 was withdrawn.

XIV. December 11, 1959. Groundnuts.

*A minimum margin of 45 percent of the value of stocks.

**Banks were required to maintain each month commencing from January 1960 average aggregate credit at a level not exceeding (i) In respect of offices opened before January 1, 1958, 90 percent of the average of the level of credit maintained by such offices in the corresponding months of 1957, 1958 and 1959.

(ii) In respect of offices opened on or after January 1, 1958, the proportion of their average aggregate level of credit against groundnuts to that of other offices should not exceed the proportion which the average aggregate level of credit against groundnuts of new offices bore to that of other offices in the corresponding month of 1959.

In addition to the permissible levels indicated above, additional limits were allotted in respect of exporters of groundnut or groundnut oil (a) to the extent of $66\frac{2}{3}$ percent of the value of the unutilised quota of a valid licence for the export of groundnuts and (b) to the extent of 50 percent of the value of the groundnut equivalent to the value of unutilised quota of a valid licence for the export of groundnut oil.

*** (i) Advances to vanaspati manufacturers, exporters of groundnuts or other oilseeds or groundnut oil and credit granted against pledge of warehouse receipts, were exempted from the margin requirement.

(ii) Demand Documentary Bills.

Other oilseeds (margin requirements only).

The margin in respect of each credit limit granted before the date of the directive was to be increased to 40 per cent and a minimum margin of 40 percent was to be maintained on fresh credit limits.

XV. January 16, 1960. Paddy and Rice.

*A minimum margin of 40 percent of the value of stocks.

**Banks were required to maintain average aggregate level of credit against the security of paddy and rice for each month commencing from February 1960 (1) in respect of offices in Andhra Pradesh and Madhya Pradesh, at a level not exceeding the average aggregate level of credit permitted to be maintained by such offices in the corresponding month of 1958 or 1959 whichever was higher; (2) in respect of offices in other States, not exceeding the average aggregate level permitted to be maintained by such offices in the corresponding month of 1958 or 1959, whichever was higher.

*** (1) Advances of offices opened on or after January 1, 1958 in centres without banking facilities up to a maximum of Rs. 1 lakh for each such office subject to the relative stocks being in the possession or under the control of the office concerned.

(2) Advances of other offices opened on or after January 1, 1958 to the extent of three times the average aggregate level of credit actually maintained by those offices in the corresponding month of 1959.

(3) Other exemptions as in the July 10, 1959 directive.

The separate limits for Orissa and Madras were removed. The margin concession given in respect of advances to purchasing agents of the Government of Orissa was withdrawn.

XVI. March 11, 1960. Shares other than preference shares.

*(1) The existing margin in respect of each credit limit granted before the date of the directive was to be raised to 50 percent of the value of shares on or before April 11, 1960 in case of parties other than members of recognised stock exchanges

and on or before June 11, 1960 in the case of members of recognised stock exchanges.

(2) A minimum margin of 50 percent was to be maintained in respect of each fresh credit limit granted on or after the date of the directive.

(3) The margin requirement applied where a bank provided finance for any budla transaction by way of a credit limit.

*** (1) A credit limit to any one party which did not exceed Rs. 5,000 whether taken separately or together with such other credit limit or limits to the same party was exempted.

(2) Advances to stock and share brokers against purchase of demand documentary bills covering stock exchange securities were exempted provided that bills are retired by drawees not later than 7 days from the date of purchase (circular dated March 17, 1960).

Where credit limits had been granted against the security of shares together with preference shares the credit limits against preference shares and other shares should be segregated and the provisions made applicable to segregated limits.

Scheduled banks were prohibited from engaging in budla transactions in respect of shares issued by any company through purchase in its name for the current settlement and sale for the next settlement.

Clean Advances

No Scheduled bank was to maintain in any month commencing from April 1960 a level of clean advances which bore to its total advances a proportion exceeding the proportion between its clean advances and total advances in the corresponding month of 1959. XVII. August 20, 1960. All Foodgrains.

*A minimum margin of 40 percent against all advances but relaxed to 25 percent against wheat to storage delivery contractors of the Punjab Government.

**Paddy and Rice.

Same as in January 16, 1960 directive.

Wheat

Banks were to maintain each month commencing from September 1960 average aggregate level of credit against the security of wheat at the average aggregate level of credit actually maintained in the corresponding month of 1958.

Other Foodgrains.

(i) In respect of offices in Madhya Pradesh and 'Uttar Pradesh 75 percent of the average aggregate level of credit actually maintained by such offices in the corresponding month of 1958.

(ii) In respect of offices in Other States the average aggregate level of credit actually maintained by offices in these states in the corresponding month of 1958.

***Same as in January 16, 1960 directive.

Separate limits in respect of wheat for Punjab, Delhi, Himachal Pradesh, Jammu and Kashmir were removed.

In partial modification of this directive (i) Banks operating in Kerala were allowed to maintain during a temporary period of three months (August, September and October, 1960) an average aggregate level of credit not exceeding 200 percent of such credit maintained by such offices in the State against the security of paddy and rice during the corresponding months of 1959. (Directive dated August 21, 1960).

(ii) For Banks operating in the Punjab, margin requirement was reduced to 25 percent in respect of advances granted by them to licensed dealers and millers in the State against the security of paddy and rice with effect from October 8, 1960 (Directive dated October 8, 1960).

XVIII. December 9 and 12, 1960.

December 9, 1960. Sugar.

The Reserve Bank of India issued a directive to scheduled banks effecting a reduction, with immediate effect, from 45 percent to 25 percent in the minimum margin requirement on advances against the security of sugar to parties other than those manufacturing sugar and to those manufacturing sugar in respect of stocks which left factory or mills' premises and on which excise duty had been paid.

This relaxation in margin requirement was called for by the comfortable stock position of sugar and the stability in sugar prices during recent months.

December 12, 1960. Raw jute and jute goods.

Advances against raw jute and jute goods came to be regulated for the first time by selective credit control. The sharp rise during recent months in the prices of raw jute as well as jute goods and the significantly sharp rise in advances against jute goods and latterly of raw jute attracted the attention of the Reserve Bank. To prevent any rapid rise in the prices of raw

jute and jute goods, especially as the latter constituted a staple export item, the directive issued by the Bank stipulated a minimum margin of 25 percent on advances against raw jute to jute mills and of 40 percent on such advances to others. Advances against jute goods were made subject to a minimum margin requirement of 40 percent.

Banks were also required to maintain in each two month period commencing from January 1961, an average aggregate level of credit against the security of jute goods, not exceeding 130 percent of the average level of credit maintained by them in the corresponding period in the immediately preceding year.

Chapter VIII

USE OF VARIABLE RESERVE RATIO

In keeping with the needs of a developing economy, the Reserve Bank of India since 1956 had been following a policy of selective credit control. It directed its policy of credit control on those spots where speculative forces had gathered to create inflationary pressures. For example, it seemed that the speculative hoarding of foodgrains, among other causes, led to the phenomenon of the food price index rising more rapidly than the general index. The Reserve Bank, therefore, issued a directive to all banks to reduce their advances against foodgrains and to raise the margins against such advances. The selective credit control was further sharpened by discrimination between producing and consuming areas. Unfortunately, the effect of the various directives issued under selective control method was disappointing. There were several difficulties faced by the Reserve Bank. Firstly, hoarding of foodgrains might not be financed wholly by bank advances. Secondly, the Reserve Bank had to take additional steps to prevent bank money from percolating into the foodgrains trade through clean advances and other means. The Reserve Bank soon realised the difficulty of insulating any particular sector or sectors against an overall increase in bank credit. Seepage of funds from the restricted to the non-restricted sectors took the edge off the policy of selective control. In 1958, therefore, the Reserve Bank introduced quantitative control through persuasion or exhortation to support its selective control measures. Banks were directed to reduce their level of advances by Rs. 80 crores during the slack season; but since no attempt was made to restrict credit expansion in the busy season, an element of uncertainty was left in the money market and uncertainty breeds speculation and to that extent, it may be said, this control measure added to the speculative forces in the economy.

Banks, however, co-operated fully with the Reserve Bank in the execution of its disinflationary directives. Between April 18 and November 21, 1958, bank advances declined by Rs. 126

crores as against an expansion in the previous busy season of Rs. 112 crores. But the index of agricultural prices rose from 106.0 in May to 116.5 in November, 1958 or by 9%.

Experience during 1959 was similar to that in the previous year. Bank advances recorded an increase of Rs. 196 crores between November 21, 1958 and May 8, 1959. At the close of the busy season, the Reserve Bank issued a directive asking for reduction of bank advances by Rs. 100 crores during slack season and reinforced it with the warning that if the banks failed to reduce advances to the required extent, the Reserve Bank might be less liberal in granting accommodation under the Bill Market Scheme in the ensuing busy season. During this period the index of agricultural prices rose from 112.2 to 118.0 or by 5% and that of industrial raw materials from 119.4 to 122.5 or by 3%. Total bank credit stood at Rs. 923 crores on November 27, 1959, as compared with Rs. 831 crores a year before. Subsequently, advances increased by Rs. 216 crores to Rs. 1139 crores on May 6, 1960 which was higher by Rs. 112 crores as compared with the corresponding week of 1959. The Reserve Bank renewed its annual fiat and directed banks to bring down advances by Rs. 110 crores. In spite of all these directives, the uptrend of prices was not halted and this perhaps started re-thinking. On March 11, 1960 the Reserve Bank for the first time announced its decision to use the weapon of variable reserve ratio.* It called upon all the Scheduled banks to maintain with itself additional average daily reserves equal to 25% of the increase in deposits accruing after March 11, over and above the existing statutory minimum of 5% of demand deposits and 2% of time deposits. On this additional deposit, the Reserve Bank agreed to pay interest to each bank at one-half percent above the average rate of interest paid by that bank on its total deposits, subject to a maximum of 4½%. Subsequently, on May 5, 1960, the Bank issued another notification requiring each Scheduled bank, with effect from May 6, 1960, to maintain with the Reserve Bank additional reserves of (1) 25% of the amount by which its total liabilities on May 6, 1960 exceeded the level as of March 11, 1960 and (2) 50% of the increase in total liabilities since May 6, 1960.

* The power to exercise the weapon of variable reserve ratio was acquired by the Reserve Bank in the Reserve Bank of India (Amendment) Act of 1956.

This method of quantitative control was taken over and above a series of selective control measures already adopted, such as regulations in respect of advances against raw jute, raw cotton, paddy, etc.

The question naturally arises—was this shift from selective control to quantitative restriction necessary? In some quarters, the adoption of this measure was characterised as unwarranted.¹ The argument in favour of this contention was that quantitative limitations on bank advances might be helpful in combating a credit-based inflation. But since the inflationary situation was mostly due to the fiscal and planning policies of the Government, restrictions on bank advances, without any change in these policies would not only not be of any use in curbing the inflationary forces, but might be positively harmful if the restrictions on the aggregate of bank credit led to a decline in employment and output. In view of this, there was no justification for this shift to quantitative control.

True, at the root of the inflationary situation was largely the high rate of investment expenditure. The public sector investment in 1960-61 was placed at about Rs. 1,170 crores of which Rs. 153 crores the Government decided to finance through borrowing from the Reserve Bank. This practice of financing expenditure through borrowing from the Reserve Bank, as is well known, resulted in an increase in money incomes which, in recent years in India, was proceeding at a faster rate than the rise in real output. Up to this stage, things just went on happening, irrespective of what the Reserve Bank did or did not do, and the price rise or the inflationary pressure resulting from this increase in money incomes could not be said to have been generated by the expansion in bank credit. But it should be pointed out that in so far as an increasing part of the rise in money incomes was being deposited with the banks and a portion of the additions to the money supply came back to the banks, their cash balances were augmented. Larger cash balances increased the ability and willingness of the banking system to lend, and this secondary expansion in bank credit would surely have its impact on prices. This expansion ratio would have been larger at a time when a significant swing was taking place from demand to time deposits. The rapid growth

¹ *Economic Weekly*, Editorial, March 19, 1960.

in time deposits noticed since 1956-57 continued in 1959-60 in which year alone they increased by Rs. 208 crores as compared to Rs. 192 crores in 1958-59 and Rs. 249 crores in 1957-58. Demand deposits increased from Rs. 643.69 crores in 1956-57 to Rs. 725.51 crores in 1959-60 or by about 12%. During the same period, time deposits showed an increase from Rs. 451.22 crores to Rs. 1,061.26 crores, a rise of 135%. Here was the scope for the application of the quantitative restrictions to slow down the rate of creation of bank credit, even though the Reserve Bank was not in a position to curb the primary expansion in investment. Moreover, it may well be argued that because some expansion in money supply was unavoidable if the Government was to finance its investment, the Reserve Bank was justified in ensuring that this was not used as a basis for the secondary expansion in bank credit.

It may be remembered here that prior to the adoption of the measure of variable reserve ratio, there was a heavy pressure on the banking system. Very low reserve ratio, high rate of borrowing from the Reserve Bank and quite a large sale of securities, together with a nearly 70 percent advances-deposit ratio of all Scheduled banks, excluding the State Bank of India, proved beyond doubt that the banks had gone to almost the maximum limit with regard to the grant of loans and advances. At the same time, the rise in industrial output, although spectacular, was not commensurate with the increase in bank credit.

During 1959, the index of industrial production had risen by 7.1%, no doubt a high rate of increase recorded so far in the index. But the average volume of bank credit during 1959-60 increased by about 9.8%, thus outstripping the rate of increase in the index for industrial production. During the four years 1955-56 to 1959-60, bank credit expanded by more than 56%, while the index of industrial production recorded a rise of only 23.6% and the aggregate national income by still smaller percentage, i.e., by 11.5% between 1955-56 and 1958-59. It is to be remembered that all this expansion in bank credit took place at a time when stringent import control restricted one important source of demand for bank credit, and the shift to time deposits, against which the banks can keep much lower cash reserve ratios, substantially increased the power of the banking system to create

credit. Thus by all evidence, bank credit had been excessive in relation to genuine needs of the economy.

A significant fact to be noticed in this connection is that although the index of industrial production recorded the highest rate of increase in 1959, a relatively smaller portion of the secured bank credit between the end of October, 1959 to the middle of February, 1960 had been granted against industrial raw materials and manufactured goods than in the same period of the previous two years. In these two years, about 83 to 84 percent of the secured bank advances had been devoted to these two purposes, while the ratio was only 63 percent in 1959-60. Surely, it would not be good economics to say that because an economy has to be developed at a rapid pace, all investment without discrimination should be encouraged. Investment may take place in inventory-building or in projects with very high profit expectations but not necessarily sound from the long-run point of view. One can hardly deny the fact that bank credit has not been properly integrated into the structure of planning. Up till now, plan priorities have little meaning to a banker. To him a firm of cosmetic products may have as much as or, even more, claim for credit than a firm producing fertilisers. This is exactly the danger against which the monetary authorities will have to guard when the financing of development leads inevitably to the emergence of inflationary pressures.

Such a situation, it may be argued, would be better tackled through the judicious manipulation of selective credit control. But a multiplication of the points at which such control is to be imposed gives rise to a lot of complications. In the face of the rise in the liquidity of the banking system, quantitative restrictions on bank credit would be necessary if only to preserve the efficacy of the selective credit control measures. The adoption of the method of variable reserve ratio was therefore only a belated recognition of this fact.

It may be suggested here that it would be better if the authorities now do away with the practice of prescribing lower ratios for time deposits. Prescription of the same reserve ratios would prevent the emergence of a situation in which a shift from demand to time deposits would lead to an increase in the liquidity of the banking system. Under the present practice, banks may induce a shift from demand to time deposits by offering higher

rates of interest on the latter. This would naturally increase their ability to lend more money on the basis of the same aggregate volume of deposits and the same amount of cash reserves.

Having explained the need of quantitative credit control, we may now proceed to examine how the banks reacted to the quantitative restrictions imposed by the Reserve Bank.

On March 18, 1960, the aggregate deposits of the Scheduled banks showed an increase of Rs. 6.37 crores. Banks were, therefore, required to transfer an additional sum of Rs. 3.52 crores to the Reserve Bank of India, and had to meet at the same time the increasing credit needs of the busy season. The volume of bank credit rose by Rs. 25.59 crores in that week. It was also necessary to provide for the larger withdrawals of cash usually found at the end of the financial year. The banks met the situation by selling securities worth Rs. 30.70 crores, and by increased resort to borrowings from the Reserve Bank and the State Bank which were respectively Rs. 20.55 crores and Rs. 2.44 crores. The sale of securities was resorted to almost exclusively by the Indian Scheduled banks, while the Exchange banks which experienced a decline in deposits increased their borrowing from the Reserve Bank by 122 percent in one week and withdrew funds previously lent at call and short notice. Next week there was again a substantial increase in the aggregate volume of deposits by Rs. 11.81 crores, and a rise in bank credit by Rs. 13.23 crores. Banks sold securities worth Rs. 14.65 crores and borrowed an additional sum of Rs. 2.65 crores from the Reserve Bank (borrowings from the State Bank increased by Rs. 2.04 crores). It may be noted here that all these were confined to the Indian Scheduled banks, the relevant items in the balance-sheet of the Exchange banks remaining more or less the same on the 25th March. After the year end requirements were met, the impounding of deposits following the sustained rise in deposits was financed by a drawing down of till money which showed a decline from 3.55 percent in the last week of March to 2.53 percent in the last week of April. The required reserves rose by about Rs. 9 crores and the cash in hand was allowed to fall by about Rs. 0.14 crores. The demand for bank credit showed only a small rise above the level reached during the last week of March. On May 6, however, the demand for bank credit rose by Rs. 11 crores, while the volume of deposits remained more

or less the same as in the last week of April. There was a small increase in the required reserves by Rs. 1.25 crores which was met by drawing down the excess balances with the Reserve Bank (Rs. 7.76 crores), larger borrowing from the Reserve Bank (Rs. 3.79 crores) and increased borrowing from banks having surplus balances (Rs. 5.4 crores). On May 6, a further Directive raising the reserve ratio of fresh additions to deposits to 50 percent was issued. This resulted in a substantial increase in required reserves which rose by Rs. 9 crores by the last week of May, following a rise in aggregate deposits by Rs. 14 crores. Fortunately this period coincided with the onset of the slack season and by the last week of May, the volume of bank credit declined by Rs. 17.8 crores from the level of May 6.

Thus banks met the immediate impact of these measures of credit squeeze by a larger borrowing from the Reserve Bank and by a sale of securities which were again bought mostly by the latter. Between March 11 and March 25, the investments of the Reserve Bank rose by Rs. 24.1 crores and other loans and advances by Rs. 20.9 crores. Thus it appears as if the loans window and the investments window were kept wide open to soften the impact of the squeeze. There was little or no impact on the volume of bank credit or on the liquidity of the banking system. In the 8 weeks from March 11 to May 6, the total of bank credit rose by Rs. 52.21 crores as against Rs. 48.69 crores during the same period of 1959. The total volume of deposits increased by Rs. 46.07 crores in 1960, while the rise amounted to Rs. 57.45 crores in 1959. A comparable year was the busy season of 1956-57 during which the volume of bank credit rose by Rs. 58.75 crores in 6 weeks from the 2nd week of March. Deposits rose by Rs. 54.84 crores. The rise in bank credit was by 113 percent of the rise in deposits in 1960, while it was 107 percent in 1957. This ratio was no doubt higher in 1956, being 119 percent. But in these years, there was no credit squeeze in operation. While the primary liquidity of the Scheduled banks (ratio of cash balances and balances with other banks in current account minus Reserve Bank borrowings to total deposits) rose on May 6 from 4.6 percent to 5.3 percent, a relatively smaller rise than in the corresponding 6 weeks of 1959 when it rose from 4.5 percent to 6.5 percent, the secondary liquidity of the Scheduled banks (ratio of money at call and short notice plus investments to total

deposits) declined from 41.6 percent on March 11 to 40.2 percent on May 6. Thus the total liquidity of the Scheduled banks actually showed a decline from 46.2 percent to 45.5 percent during these 6 weeks. In the case of all other Scheduled banks excluding the State Bank of India, the primary liquidity would be found to have declined from 6.2 percent to 5.5 percent and the secondary liquidity from 39.8 percent to 34.3 percent during these 6 weeks. In 1959, the total liquidity rose from 44.5 percent in the 2nd week of March to 45.3 percent in the 1st week of May. Thus, on the whole, the immediate impact of the credit squeeze cannot be said to have been in any way restrictive.

As already stated, the Reserve Bank attempted a further tightening of the belt on May 6, 1960 by raising the required ratio against further additions to deposits to 50 percent. This measure came at a time when the slack season also started and the volume of bank credit declined almost continually till the end of August when it recorded a fall of Rs. 38.45 crores. In the previous slack season of 1959, however, the level of bank credit had fallen by Rs. 90.81 crores on August 28 as compared to that on May 8. It may be mentioned here that the comparable slack season declines were those of 1955 and 1956, when the volume of bank credit fell by Rs. 20.24 crores and Rs. 33.99 crores respectively. During September, 1960, the volume of bank credit rose again by Rs. 32.9 crores, thus practically nullifying the contraction of the previous four months. This was made possible, as before, through a recourse to the loans window of the Reserve Bank. During the 1st week of September, borrowing from the Reserve Bank rose by Rs. 37.8 crores, though in subsequent weeks, it declined by about Rs. 21.4 crores. Even then borrowing from the Reserve Bank stood higher by Rs. 30.3 crores over the level in the same period in 1959. Considering the Reserve Bank's attempts at credit squeeze, such generosity on its part was rather perplexing.

The Reserve Bank, however, soon realised the dangers of keeping the loans window wide open. To avoid the mounting pressure of such borrowing each Scheduled bank was allotted a quota up to which it was permitted to borrow at the Bank rate. Any borrowing above this quota was made subject to penalty rates. At the same time, banks were directed to raise their

lending rates by not less than $\frac{1}{2}$ percent, subject to a minimum of 5 percent. This was made effective from 1st October.

This, no doubt, made a dent on the market, as is evidenced by the fact that in the next two months bank credit declined by Rs. 29.22 crores and borrowing from the Reserve Bank also contracted from Rs. 33.44 crores (end of September) to Rs. 12.29 crores (end of November). But while the free access to the loans window was restricted, the investment window remained open as before so that funds continued pouring into the banking sector abundantly. Investments of the Scheduled banks declined by Rs. 37.91 crores from the level of the last week of September, while the aggregate amount of rupee securities of the Reserve Bank rose by about Rs. 53 crores during these two months. If PL 480 transactions were excluded, the fall in the total investments of the Scheduled banks would amount to Rs. 23.91 crores and the rupee securities of the Reserve Bank would be higher by about Rs. 39 crores. As a result of the required ratio against additions to deposits being lowered to 25 percent from November 11, in the next two weeks some funds were released from the previously impounded balances kept with the Reserve Bank. In spite of this, the Scheduled banks allowed their till money to dwindle to as low as 2.39 percent of the aggregate deposits against 2.44 percent in the last week of September, and the total cash reserves were drawn down by Rs. 8.4 crores.

During the entire slack season of 1960, i.e., from May 6 to November 25, (November is included in the slack season owing to the decline in bank credit) total bank credit declined by only Rs. 34.78 crores. This was one of the lowest rates of contraction, the only two other years of comparable contraction being 1955 and 1956. The level of bank credit shows that the screw applied by the Reserve Bank did not prove to be an effective deterrent. The secondary liquidity of the Scheduled banks declined from 40.2 percent on May 6 to 38.2 percent on November 25 while their primary liquidity rose to 8.0 per cent. This resulted in a rise of the total liquidity of these banks from 45.5 percent to only 46.2 percent during this period. But in 1955, another equally bad slack season, total liquidity of the Scheduled banks rose from 46.9 percent in the 2nd week of May to 51.2 percent in the last week of November. In the slack season of 1957, the ratio was 43.5.

percent in both weeks. Thus, in this respect also the squeeze does not appear to have been much effective.

One might argue that the squeeze was not expected to bring about any serious decline in bank credit and that its main objective was to secure a diminution of the rate of growth in bank credit by lowering the money creation multiplier. In the absence of this squeeze, there would have been a larger rate of expansion in bank credit during the busy season and a much smaller rate of contraction during the slack season as actually took place in the slack season of 1956. The demand for bank credit remained very high even during the slack season as evidenced by the continuation of high money rates, and the reduction in bank credit, however small, had been effected through the application of the squeeze. The figures relating to bank credit do not, however, lend support to this view. The annual average level of bank credit during 1960-61 was higher than that of 1959-60 by 17.5 percent as would be evident from the following table.

TABLE 1
INCREASE IN BANK CREDIT (ANNUAL AVERAGE OF FRIDAYS)
OVER THE LAST YEAR

1950-51	..	..	3.8%	1956-57	..	..	23.6%
1951-52	..	..	19.3%	1957-58	..	..	13.9%
1952-53	..	..	8.5%	1958-59	..	..	0.9%
1953-54	..	..	1.2%	1959-60	..	..	9.8%
1954-55	..	..	12.5%	1960-61	..	..	17.5%
1955-56	..	..	13.6%				

The table shows that the rate of increase in bank credit that took place in 1960-61 was outstripped only in two years out of ten. In all other years it was much lower than that of 1960-61. It was nearly double the average rate of the last 10 years. With the PL 480 deposits excluded, the advances-deposit ratio was as high as 66.2 percent in the last week of November, just on the eve of the next busy season. Surely, this could not be regarded as encouraging.

Moreover, the national income at current prices increased by Rs. 960 crores between 1948-49 and 1954-55, while the level of bank credit increased by Rs. 115.52 crores, i.e., the expansion of bank credit formed 12.0 percent of the former. In the next five years, 1956-57 to 1959-60, the national income increased by Rs. 3,230 crores while bank credit increased by Rs. 430.48 crores.

The rise in bank credit thus formed 13.3 percent of the national income. On the basis of the Planning Commission's estimate of national income at Rs. 14,500 crores for 1960-61 at 1960-61 prices, the increase in bank credit that took place in 1960-61 would be of the order of 21.2 percent of the rise in national income. Thus the rate of growth in bank credit was not slower during 1960-61.

The continuance of high money rates throughout the slack season was probably the reason of the feeling that there had been a curb on bank credit. No doubt money rates continued at high levels throughout the year 1960-61. The rate for call money from banks rose slightly by $\frac{1}{2}$ percent in March and continued at that level throughout the slack season. It rose to an average of $4\frac{1}{2}$ percent on October 22, a level higher by 2 percent above that of the last following the application of restrictions on access to the Reserve Bank. The rate came down subsequently in November and December, after which it rose to 5.21 to 5.26 percent throughout the last 3 months of the financial year. But the prevalence of such high rates on call money for bank credit is not unusual. For example, in the slack season of 1957 also, all money rates continued at high rates (3 to $3\frac{1}{2}$ percent). But during this period there was a comparatively slower rate of increase in bank deposits.

A mere rise in interest rates may not necessarily mean smaller availability of credit. Whatever immobilisation of balances took place following the measures of squeeze was easily neutralised by drawing down cash balances and through sale of securities to the Reserve Bank.

The existence of high interest rates only reflects the growing scarcity of capital resources of a developing economy and if the Reserve Bank's measures hastened the rise in rates, they served only to bring the economy nearer to equilibrium. The continued existence of inflationary pressures, stimulated to some extent by the high hopes raised by the Third Plan with its promise of more foreign aids, encouraged optimistic moods in general and increased the liquidity of the whole economy. This again resulted in an increased propensity to spend and to invest with a consequent rise in the demand for money. This ever-increasing demand for money led to a rise in interest rates. The moods and expectations of the business community were well reflected in the stock markets

where the index numbers of variable dividend industrial securities (base 1952-53=100) showed a rise from an annual average of 155.3 in 1959-60 to 171.7 in 1960-61, i.e. by more than 10 percent. There was also a good deal of buoyancy and speculative fervour in the capital, bullion and commodity markets. The price of gold rose continuously throughout the year and reached new heights. All this buoyancy no doubt was dampened to some extent in September and October 1960 following the Directive restricting the free access to the Reserve Bank. But this set-back was temporary and the buoyant trend was noticeable again from December. This optimistic outlook of the business community raised the demand for funds and consequently the rates of interest. Since a rise in interest rates may raise costs of production and so prices, it may not be looked upon with favour. But higher interest rates, by raising costs, may prove to be a deterrent to investment expenditure, and that was also the objective of the credit squeeze measures of the Reserve Bank. Moreover, a rise in the structure of interest rates may be regarded as a positive advantage as the rates are rather low in the organised and high in the unorganised sector. It is time that this disparity, maintained in the interest of debt-financing, should go so that any trend towards the flow of funds into the unorganised sector in search of higher interest yields might be counteracted.

The budgetary policy followed in a country is an important part of its economic policy. It has tremendous potentialities for good as well as evil, for, a correct policy may as much create a suitable environment helping the solution of many complex problems as a wrong one may lead to economic chaos of the worst type.

In the early Keynesian era, discussions on fiscal policy mostly centered round the problem of short-run economic stability. Fiscal operations were designed primarily to counteract cyclical fluctuations by influencing the aggregate effective demand. For this pre-occupation with the cycle problem there were, of course, historical reasons. The depression of the thirties and the inflation of the war and post-war years—these were pressing short-run problems that absorbed all attention relegating to the background the long-run problem of growth in a dynamic economy. Fiscal policy, in these years, meant, for all practical purposes, a contra-cyclical policy.

More recently, however, there has been a change in regard to the aim of fiscal operations. The aim now is that of ensuring conditions of stable growth. Since the primary problem in an under-developed economy is to secure rapid economic growth, fiscal policy in such an economy has to be tailored to the needs of an accelerated pace of growth.

Harrod and Domar, more notably than any other economist in recent years, have been pioneers in reviving the interest in the study of the problems of growth that went into eclipse after Adam Smith and his immediate followers. Both Harrod and Domar have discussed what rate of income growth in a dynamic economy will ensure equilibrium from year to year¹. Though differing in

¹ R. F. Harrod, 'An Essay in Dynamic Theory', *Economic Journal*, Vol. XLIX, No. 193, March 1939, pp. 14-33; *Towards a Dynamic Economics*, London, 1948; 'Supplement on Dynamic Theory', *Economic Essays*, Macmillan and Co. Ltd., London, 1952. Evsey Domar, 'Expansion and Employment', *American Economic Review*, Vol. XXVII, No. 1, March 1947; 'Capital Expansion, Rate of Growth and Employment', *Econometrica*, Vol. XIV, No. 2, April 1946; Other essays by the same author along with the above two reproduced in his *Essays in the Theory of Economic Growth*, Oxford University Press, New York, 1957.

details, their models of growth are similar in substance. Here we may discuss their theories only to the extent necessary to derive the parameters for a realistic fiscal policy.

Investment, a crucial factor in the process of growth, has a dual role according to Harrod and Domar. On the one hand, investment generates income; on the other, it increases the productive capacity of an economy by enlarging its capital stock. Assuming the capital stock as given, Keynesian analysis confines itself only to the income-generating effects of investment². Such an assumption may be valid in an analysis of essentially short-run problems. But when we extend our view to the long run, we must also consider that net investment augments over time the productive capacity of an economy. If the productive capacity of capital goes on increasing unaccompanied by a proportionate increase in real income and output, excess or idle capacity will grow in the economy. This, in its turn, will induce entrepreneurs to cut back investment outlays with the result that income and employment will decline in subsequent periods. In other words, the economy goes off the equilibrium path of steady growth. This shows that in the long-run sense, employment is a function of the rate of growth of investment and income. Therefore, in order to prevent long-run disequilibrium and unemployment, income must be made to grow at a rate sufficient to ensure the full-capacity use of an expanding capital stock. This 'required' rate of income growth may be depicted as the full-capacity rate of growth.

Harrod's equation for this rate of growth is $Gw = \frac{s}{Cr}$

in which Gw is the 'warranted rate of growth', s the proportion of income that is saved (S/Y), and Cr the value of capital required to produce a unit increment of output³.

Gw or the 'warranted rate of growth' in Harrod's equation is synonymous with our 'full capacity growth rate'. From the equation it is clear that for the fullest utilization of capacity income must grow at the annual rate of $\frac{s}{Cr}$.

The required level of income necessary for the full and continued utilization of capacity of a growing capital stock may

² *General Theory*, p. 245.

³ R. F. Harrod, *Towards a Dynamic Economics*, New York, 1966, p. 81.

also be stated in an alternative equation, $Y_{t+1} - Y_t = osY_t^*$. The equation means that national income in year $t+1$ must exceed that of year t by the amount of added productive capacity which is equal to osY_t , where o is the reciprocal of the accelerator co-efficient * and s is equal to the average—the marginal propensity to save. The term os corresponds to $\frac{s}{Cr}$ in Harrod's equation.

The notation used in Domar's model is ΔI in his equation $\frac{\Delta I}{I}$ and is equal to Gw or the full-capacity growth rate. If the actual rate is designated by G , then $G = Gw$ becomes the condition of equilibrium growth.

Disequilibrium will creep in when G and Gw are not equal. If $G > Gw$, conditions of secular inflation will arise. Since income grows at a faster rate than warranted by the growth in capacity, there will result a deficiency of capital goods and increasing pressure on capacity. Production falls short of aggregate demand and secular inflation takes place. If $G < Gw$, excess capacity accumulates in the economy leading to a decline in investment, employment and income and there is secular depression.

Thus, in order to maintain stability in the long run, public policy should be so designed as to secure an equality between G and Gw . But there is another important variable which we must consider while stating the full conditions of long-run growth equilibrium. That is the full-employment rate of growth or Gn . This is the rate of growth of output necessary for offering full employment to a growing labour force with rising labour productivity. If n is the annual rate of growth of the labour force, and h is the rate of growth of labour productivity, then $Gn = n + h^5$. If $Gn = Gw = G$ there is equilibrium full-employment growth. But this equilibrium is disturbed

* D. Hamberg, *Economic Growth and Instability*, New York, 1956, p. 29.

* There may be a controversy as to whether we should consider the value of the marginal capital co-efficient or the accelerator co-efficient. Professor Hamberg says that 'in an enquiry into the rate of income growth required to absorb into production a growing stock of capital, it is necessary to limit our attention to increases in productive capacity that are the result of induced investment only'.—D. Hamberg, *Economic Growth and Instability*, New York, 1956, p. 29.

* K. K. Kurihara, 'The Fiscal Role of Government in Economic Development', *Indian Economic Journal*, Vol. XXXVII July 1956, p. 40.

when G_w diverges from G_n . If $G_n > G_w$, that is to say, if the rate of growth of output necessary to secure full-employment to the growing labour force is more than what the full utilization of the capacity of the growing capital stock can ensure, there may be a tendency to secular inflation in the economy. This is so because G , the actual rate of growth, tends to reach G_n under the pressure of unemployment.

If, on the other hand, $G_n < G_w$, secular stagnation would be the obvious result because of the fact that the rate of growth of capacity is more than sufficient to afford full employment to the growing labour force. Excess capacity would appear leading entrepreneurs to curtail investment which, in its turn, would create unemployment and depression.

Since in a developed economy G_w may exceed G_n , there may arise conditions of secular depression. Under these conditions, the maintenance of long-run stability of growth would necessitate a diversion of resources from investment to consumption. In terms of Harrodian model, it is necessary to lower G_w which, as indicated earlier, is equal to os . The possibility of a high G_w in a developed economy follows from a high s or (S/Y) . In such a situation, stability demands measures designed to lower the ratio of savings to national income. The opposite policy of reducing consumption would be necessary when $G_n > G_w$. Thus, sometimes a fall, sometimes a rise in s or the saving/income ratio may be necessary in an advanced economy.

In an under-developed economy, on the other hand, one does not come across conditions which may in the near future necessitate a lowering of s . Since the bulk of the population lives on the margin of subsistence, the marginal propensity to consume is very high so that supported by a rising consumption demand, output may grow at a rate sufficient to ensure full utilization of capacity. The problem rather is to secure an increase in G_w which remains chronically below G_n in such an economy, a fact which explains the existence of a large volume unemployment and under-employment. Since G_w is chronically less than G_n , the economy suffers not only from the scourge of vast unemployment but also from the danger of chronic secular inflation. Any attempt to attain to a high rate of growth of output which takes G above G_w brings in its wake an inflationary tendency because real output fails to grow at a rate appropriate to the rate of increase in income.

Under these circumstances, the aim of fiscal policy may be said to be to promote the highest possible rate of capital formation without at the same time engendering inflation. A higher rate of saving fructifying into investment will so augment the productive capacity of the economy as to create more employment opportunities and at the same time will reduce the consumption demand. Thus a rise in s or the ratio of savings to income will achieve the twin purposes of reducing unemployment and maintaining stability.

If the primary problem in a developing economy is to raise the saving/income ratio, the main task before the tax system in such an economy should naturally be to stimulate capital formation and to reduce extravagant consumer demand.

As is well known, not merely the level of per capita income, but also and perhaps more importantly, the pattern of income distribution determine the aggregate volume of savings in a community. In other words, the share of the national income accruing to the upper income groups and the share of property income in total income determine more importantly the potential rate of savings in an economy, although the level of per capita income may be important for the long-term growth of savings.

According to Mr. S. J. Patel who roughly worked out the distribution of national income in India for 1950-51,⁶ the share of property incomes in India and the United States is not very different. According to Mr. Patel's computations more than half of the national income is accounted for by the income of the self-employed; wages and salaries constitute nearly 23 percent of the total, which is much smaller than the share received by wage and salary earners in the U.S.A., but gross income associated with property ownership in India amounts to a little more than 23 percent of the total. In broad terms, the property income in the U.K. and the U.S.A. also has varied from 20 to 25 percent of the total over the last ten years or so. But while in the U.S.A. a considerable part of property income is saved, in India no such saving takes place. A plausible explanation for this given by Mr. Patel is as follows:

"Although per capita income in India is low, the possible rate of savings does not have to be significantly lower than in

⁶S. J. Patel, 'The Distribution of the National Income of India, 1950-51', *The Indian Economic Review*, Vol. III, No. I, February 1956. p. 8.

the developed countries, for the proportion of the saving-generating income, or gross property income, in both cases is approximately the same. The lower rate of productive investment in India may, therefore, be explained, not by a reference to the low average income, but the preponderance of 'feudal' income (in property income), which in the main is sterile at present for furthering economic development".

This clearly shows that there is a marked divergence between the total volume of savings and the volume of savings available for productive investment. It is a well-known fact that in all pre-industrial economies, agriculture contributes more than half of the national output and a significant part of this goes to the 'feudal' proprietors and intermediaries. Such surplus may be found in other sectors too. Not only in the pre-industrial stage but in the initial stages of development also, a great part of this surplus originates in the agricultural sector and is mostly appropriated by landowners, money lenders and traders who are usually not in the habit of utilizing the surplus for productive investment. But what is required for purposes of economic development is the effective utilization of the surplus currently generated in the economy. A Communist country can achieve this by complete socialization of industry and collectivization of agriculture. In a country like India, which is committed to 'democratic' planning, the alternatives are naturally voluntary saving and, in its absence, taxation. Since the lack of entrepreneurship and ability of a high order in the industrial sector and the existence of feudal outlook and habits in the agricultural sector are factors inhibiting the growth of savings and productive investment at a rapid pace, the principal aim of tax policy in India should be to mobilise the economic surplus currently generated in different sectors of the economy, channel it into productive investment and to enlarge its size at each succeeding stage.

Mobilisation of the economic surplus for development should then be the overall objective of tax policy. Given this broad objective, we may enunciate certain fundamental principles that the tax system in India should follow.

The first principle should be that each person should be called upon to pay tax in proportion to the economic surplus which he does not, on his own, utilize for productive investment. The surplus element in an individual's income may be said to consist

of what is over and above the minimum consumption necessary for efficiency and for incentives.

The second principle of taxation should be that it must also be used to mobilise the increments in the surplus that would result from the developmental efforts. This is the same thing as raising the incremental saving ratio which means that taxation should be so designed as to prevent consumption from rising proportionately with the increase in income.

The third important principle should be the income-elasticity of taxation. This means that as national income rises, taxation as a proportion of national income must also rise. This would necessitate taxes on goods that have a high income-elasticity of demand and also a greater degree of progression in income tax.

The last principle should be the principle of equity. If taxation is used primarily as an instrument of economic development, in the demands of equity the sacrifices involved in rapid development should be equitably distributed among different sections of the population. In practice this would mean that if the poorer sections are to be restrained from increasing their consumption to the full extent of the rise in their incomes, the richer classes must also be prevented from using their surplus for extravagant consumption.

Having laid down the main principles of taxation for India, we may now briefly examine how far the tax administration over the last decade has really contributed to the fulfilment of the broad objective of mobilising the economic surplus by following these principles.

One important fact noticeable in this connection is that over the last decade, there has actually been a decline in the importance of direct taxation in the tax structure. According to the recent calculations⁷ made by Dr. V. K. R. V. Rao, while taxes in income and property contributed 32.6 percent of the total tax receipts in 1951-52, the percentage came down to 29.5 in 1960-61. The

⁷ V. K. R. V. Rao, 'Public Finance, Economic Growth and Redistribution calculations made by Dr. Rao are reproduced below : of Income in India', *The Economic Weekly*, August 26, 1961.

TABLE 1
COMPOSITION OF TAX RECEIPTS
(In million rupees)

Taxes on	1951-52		1960-61	
	Receipts	% of total	Receipts	% of total
Income and property ..	2448	32.6	3866	29.5
Commodities & services ..	4457	59.3	8232	62.7
Transactions ..	2.4	3.6	445	3.4
Others ..	339	4.5	576	4.4
Total ..	7518	100.0	13119	100.0

The total of all direct taxes paid by income tax assesseees declined from 1.96 percent of national income in 1951-52 to 1.92 percent in 1959-60 (including the yields from the new taxes such as Estate Duty, Expenditure Tax, Wealth Tax and Gift Tax), while the proportion of national income received by this class rose from 7.9 percent to 9.3 percent over the same period. Similarly Dr. Rao's calculations would show that while individuals paying income tax increased their share of the national income from 4.77 percent in 1951-52 to 5.78 percent in 1959-60, the proportion of their income paid as tax actually declined from 16.9 percent to 13 percent during the same period. This is illustrated in the following table :

TABLE 2
INCOME OF INDIVIDUALS ASSESSED TO TAX AS PROPORTION
OF NATIONAL INCOME
(In million rupees)

Year	Assessed income	Tax	Income as a proportion of national income	Tax as a proportion of assessed income
1951-52 ..	4755	803	4.77	16.9
1952-53 ..	4257	775	4.34	18.2
1953-54 ..	4704	752	4.49	16.0
1954-55 ..	4693	730	4.85	15.6
1955-56 ..	5005	794	5.01	15.9
1956-57 ..	5548	876	4.88	15.9
1957-58 ..	6050	903	3.78	14.9
1958-59 ..	6924	942	5.49	13.6
1959-60 ..	7422	965	5.78	13.0

This shows that the tax system in India over the last decade has not fulfilled the objective of effectively mobilising the economic surplus currently generated. The important principle that taxation as a proportion of national income should rise as national income rises does not seem to have been fully satisfied.

On the question of equity also, there is evidence to show that the sacrifice made in indirect taxation for economic development has not been equal among all sections of the population. The following table showing a commodity breakdown of Union Excise Duties would reveal that while the proportion of duties on "wage goods" to total Central Excises has remained more or less stationary at about 40 percent, the same on "amenities and luxuries" has declined from 52 percent in 1948 to 27.2 percent in 1960-61.

TABLE 3
EXCISE REVENUE BY GROUPS OF COMMODITIES*
(In crores of rupees)

Year	Wage-goods	Amenities & Luxuries	Intermediate Materials & Industrial Raw Products	Miscellaneous	Total
1948-49 (Accounts)	20.96 (40.6%)	26.97 (52.0%)	3.46 (6.70%)	0.36 (0.70%)	51.65
1960-61 (Revised)	159.11 (39.8%)	108.49 (27.2%)	120.10 (30.1%)	11.78 (2.9%)	399.48

Sources: *Report on Currency & Finance, 1960-61*; 'Indirect Taxes—Retrospect & Prospects', *Tata Quarterly*, October, 1959.

From the table one may easily infer that the richer sections of the population have not borne the burden of indirect taxation in proportion to the increase of their share of national income.

Similarly, the contribution made by the agricultural sector as a whole to the financing of public expenditure on social and economic overheads does not seem to be much encouraging.

Incomes assessed to income tax cover only non-agricultural incomes. Agricultural incomes are neither subject to income tax nor to any of the direct taxes imposed by the Centre. They pay land revenue which is levied mostly on a flat rate subject to differences in productivity per acre and only the higher income

* Wage-goods consists of kerosene, sugar, matches, vegetable products, coffee, tea, foot-wear, soap and cotton cloth. (Revenue from the additional excise duties on textiles is included, though a part of it belongs to other textile fabrics, as the separate breakdown is not available). 'Amenities and luxuries' include artificial silk, tobacco, woollen fabrics, motor spirit, motor cars, electric fans and electric bulbs. (The yield from tobacco is partly from manufactured and partly from unmanufactured tobacco. Since a separate breakdown is not available, the total is included). 'Industrial Raw Materials and Intermediate Products' include steel, cement, coal, tyres, diesel oils, electric batteries, oils and oilseeds, vegetable non-essential oils, paper, paint and varnishes, rayon and synthetic fibres, industrial fuel oils, copra etc.

groups in agriculture pay an agricultural income tax which has a mild degree of progression. In view of this, it is difficult to measure on comparable levels the incidence of direct taxes on agricultural and non-agricultural incomes. According to the rough calculations made by Dr. Rao, while non-agricultural income exceeding Rs. 3000 per annum were paying about 14 percent of their income as direct taxes, agricultural households with incomes exceeding Rs. 2500 per annum were paying by way of direct taxes (including land revenue and agricultural income tax) only about 5 percent of their incomes.

It is also likely that the income of this better-off class in the agricultural sector has been increasing during the last ten years as a proportion of total agricultural income. Thus it appears that the better-off among agricultural classes have not paid taxes in proportion to the increase in their money incomes. In other words, taxation has not been effectively used to mobilise the surplus generated in the agricultural sector.

As shown earlier, during a period of economic development agricultural income tends to grow at a higher rate than non-agricultural income because of a relative rise in agricultural prices. Since the average propensity to save in the agricultural sector is extremely low, it is necessary to mobilise a larger proportion of agricultural income for investment in the industrial sector. This may be done by levying taxes on such non-agricultural commodities as kerosene, carts, and various agricultural implements which are actually used in the agricultural sector. This may produce also another good effect. If agriculturists are made to buy these things at higher prices, that is to say, if their commitments in terms of cash are increased, the marketed surplus of agricultural produce may increase.

Ploughing back of the profits from public enterprises may be an important source of capital formation in an economy with an expanding public sector. But many of the public enterprises in India, as recent studies show⁸, are not making any sizable profit and some of them are actually running at a loss. Public enterprises are still in their infancy and the need for capital issues and borrowings currently exceeds the possibilities of ploughing back.

⁸ Prof. V. V. Ramanadham, 'Profits of Public Enterprises', *Applied Economic Papers*, Vol. I, No. I March 1961, Department of Commerce, Oamania University, p. 10-15.

It may be noted here that the U.S.S.R. and other centrally planned economies meet most of their requirements from turnover taxes on state-enterprise products and from profits of state enterprises. In the war and post-war period many Latin American countries also have gained considerable revenue from state-owned enterprises. In India the present trend seems to be towards a gradual expansion of the public sector which has already taken up many commercial and industrial undertakings such as electricity, airways, road transport, fertiliser production, machine-tool making, locomotive-manufacture etc. Obviously, the question of price policy in respect of the products of public enterprises becomes important in the determination of profits. Prices may either be charged on a fair cost basis or they may include a tax or a subsidy element. Studies of balance sheets of companies in India and elsewhere show that a substantial portion of the funds for expansion is obtained from the undistributed profits. The prices charged by private firms are thus sufficient not only to cover the costs including distribution of dividends and payment of taxes, but also to leave enough for undertaking expansion activities. Prices of goods and services sold by public enterprises may be fixed on a parallel basis so that they may yield enough to pay their money costs and at the same time leave a handsome revenue in the hands of the Government.

CONCLUSION

The post-war rise in prices has two broad phases—the first phase covering the period 1945-50 and the second phase beginning with the Five Year Plan. The rise in prices in the immediate post-war period was to a large extent a legacy of the war-time expansion of liquid assets and its inflationary potential. With the cessation of hostilities, although the huge war expenditure had disappeared, the enormous amount of currency that had already been pumped into circulation was still there. By December 1948, the latent inflationary pressure had been converted to an open inflation, as in the expectation of bringing the hidden stocks of goods to the surface, the Government of India decided to abolish all physical controls over goods in November, 1947. There were, however, several factors at work which did not bring about the expected recession in prices. First, there was the rise in the money wages, the index number of money wages (1939=100) showing a rise from 218 in 1946 to 269 in 1947 and to 322 in 1948. Secondly, there were continued deficits in the Government of India's budgets in these years leading to a corresponding expansion in money supply with the public which rose by Rs. 106 crores between 1946-47 and 1947-48. Moreover, so far as the commercial banks got a part of the money put into circulation by deficit budget operations and could thus expand the volume of credit on the basis of augmented reserves, deficit budgeting itself gave an impetus to the increase in scheduled bank credit which rose from Rs. 301.12 crores in 1945-46 to Rs. 442.09 crores in 1949-50. Thus up to 1948 there were higher rates of earnings for the wage-earners, continued deficits in the Central Government's budgets accompanied with a substantial increase in scheduled bank credit leading to some expansion of money supply. All these factors had the effect of increasing the purchasing power at the disposal of the public. But against this expansion of purchasing power, there was actually a decline in the output of

many industrial and agricultural commodities. The inevitable result was the rise in prices.

But the inflationary pressure in the economy seemed to have been exhausted by the end of 1948. This is quite evident from the fact that even the devaluation of the rupee in September, 1949 did not raise prices to the extent anticipated and by the end of December 1949, the general index had actually declined to 381.3 from 383.6 twelve months before.

Besides the anti-inflationary measures taken by the Government, an important factor in the maintenance of stability of prices had been the increase in food production in the years 1948, 1949 and 1950 over the levels in 1946 and 1947. This stability in prices was disturbed by the outbreak of the Korean War in June 1950. But the rate of increase in prices that took place in India was slower than that in a number of other countries such as the U.S.A., the U.K., Australia and Canada. While the uptrend in prices continued after April, 1951 in Australia, the U.K., South Africa and a number of other countries, in India prices started a downward course from that month. This shows that the full impact of the inflationary pressure in India had already been spent by the end of 1948 and but for the devaluation and the Korean flare-up, prices would probably have begun their downward course.

Meanwhile, the continued rise in prices in the immediate post-war period and the emergence of new inflationary pressures due to devaluation and the Korean War impressed upon the monetary authorities the need for a reversal of the cheap money policy followed so long. In India, the retreat from cheap money policy came in November, 1951 although such a retreat had been effected much earlier in other countries. However, the new monetary policy adopted in November, 1951 fulfilled its immediate objectives of preventing a large expansion in money supply during the busy season and in enabling the Reserve Bank to have more effective control over the total volume of bank advances. Moreover, the diminution in the volume of credit restricted the scope of speculative trading which, in its turn, had its impact on the downtrend in prices.

The First Plan was put into operation from April, 1951. The First Plan period reveals several distinct phases of price-movements. The decline started since mid-1951 was arrested after

March, 1952 ; this was followed by a short boom as shown in the rise in prices from March, 1952 to March, 1953 ; then a period of relative steadiness in prices during 1953-54 which was followed again by a recession lasting up to June, 1955 after which there was a reversal. These booms and recessions were, however, not deep enough to produce violent fluctuations in prices so that over the First Plan period as a whole there was comparative stability of prices.

Substantial increases took place in agricultural and industrial production during this period. This explains the relative stability of prices over the Plan period in the face of such inflationary factors as large-scale Plan expenditure, deficit financing, increase in bank credit, and a substantial expansion of money supply.

The uptrend in prices since June, 1955 may be described as the advent of growth inflation in the Indian economy. The First Plan was nearing its completion and the formulation of the Second Plan was progressing. In the last year of the First Plan the Indian economy experienced the largest absorption of money supply, witnessed the largest amount of investment outlay in the public sector and was administered the heaviest dose of deficit finance. All these factors had the effect of swelling the aggregate effective demand in the economy. Against this rising demand, the supply of many articles, particularly of the food group, was not satisfactory. Consequent on the increasing investment outlays from year to year, per capita income also increased. Because of the high income-elasticity of demand for food, most of the rise in income came to be spent on food articles. Since there were short-falls in food production, food prices started rising from May-June, 1955.

At a low level of income in the early stages of development people could not consume superior goods and therefore the demand for food continued to be high so that the failure of foodgrains production to rise appropriately with the rising pressure of demand inevitably caused food prices to rise. Thus the inflationary impact of the growth process came to be felt most upon food prices. But the rise in food prices induced at a later stage a rise in other sectoral prices. The persistent rise in food prices caused wage increases which, in turn, led to a rise in costs of production in manufacturing industries. In this way, the inflation that started

with the rise in food prices was gradually converted to a general cost inflation.

The relative rise in food prices, i.e., the relatively greater imbalance in the agricultural sector, has important implications. Because of the relatively higher prices of agricultural products, there takes place a shift of income in favour of the agricultural sector. Since, however, the average propensity to save among the agriculturists is smaller than that among the non-agriculturists, every shift of income in favour of the agricultural sector tends to reduce the average propensity to save of the whole economy and hence the aggregate volume of saving.

Moreover, since food prices and the prices of raw materials rise faster than the prices of goods sold by the non-agricultural sector, the latter has to spend a larger proportion of its income for buying agricultural products, the demand for which is often inelastic. Thus the sector which is the main source of saving is forced to save less while the sector whose propensity to save is relatively smaller gets more income. The net effect is a decline in the aggregate volume of saving. But an economy in the process of development can hardly countenance a situation in which the aggregate level of saving tends to fall. Saving as a proportion of national income in such an economy should rise as national income rises firstly to achieve a higher rate of investment in the interest of a rapid pace of development and secondly, to prevent the forces of inflation to which such an economy is constantly exposed as a result of heavy investment outlays.

In view of the imperative need for larger savings, agricultural prices must be kept down either by reducing the demand for agricultural produce or by increasing its supply. If neither of these can be done, an appropriate relationship has to be maintained between agricultural and non-agricultural prices so that changes in the terms of trade in favour of agriculture may not adversely affect the growth of savings in the economy.

As the Second Plan was progressing, the inflationary forces in the economy gathered further momentum. So it was thought necessary to check these forces of inflation. But while preventing inflation, utmost care had to be taken to see that the genuine needs of development were not ignored. Therefore, the Monetary Authorities were called upon to evolve a growth-oriented monetary policy tuned to the twin objectives of holding the forces of inflation

in check and of promoting the process of growth. Such a policy was reflected in the adoption of selective credit control measures by the Reserve Bank of India. It was rightly realised that the problem of credit control in India was not only to regulate the total quantity or cost of credit but also to prevent its overflow in particular directions. All demands for credit might not be "legitimate" in the sense of being essential to the genuine demands of development. Some of them might be for socially undesirable purposes. Such risk of anti-social activities was particularly serious at a time when money supply was substantially expanding and prices tended to rise under the pressure of economic development. In a rising market, it becomes profitable for producers and traders to hold on to their stocks of essential goods and if bank credit is made freely available to them for carrying such stocks, hoarding and profiteering are encouraged resulting in further aggravation of the inflationary forces. In such circumstances, the Central Bank has to see that bank finance does not become easily available for the speculative holding of stocks, while doing nothing to withhold funds from genuine business needs. In a developing country like India, selective control is all the more important because of the varying degrees of responsiveness of the different sectors of the economy to changes in money supply and the rate of interest.

When in March-April, 1956, it was observed that banks' advances against paddy and rice had shown a particularly large increase and that the prices of these commodities had shown an abnormal rise, the Reserve Bank issued, for the first time, on May 17, 1956, a directive asking all scheduled banks not to increase any credit limit in respect of advances against the security of paddy and rice or sanction any fresh credit limit in excess of Rs. 50,000 in respect of such advances. This measure was subsequently followed by a spate of directives covering many essential commodities such as jute, raw cotton, sugar, groundnut etc. in respect of which speculative holding was possible. The Reserve Bank also modified the directives issued earlier, sometimes tightening and sometimes relaxing the control measures according to changed circumstances, thus showing a remarkable flexibility in the operation of selective credit controls.

Besides the adoption of selective credit control, a reorientation in the minimum reserve policy of the Reserve Bank also became

necessary in view of the steady growth of bank deposits in the country. The importance of variable Reserve Ratio as a method of credit control grows with the growth of bank money in relation to currency in circulation.

One noticeable feature in the growth of money supply during the Second Plan period was the remarkable expansion in the deposit-money component of money supply. While for the entire First Plan period deposit money expanded by 4.8 percent, it increased by 23.5 percent during the first four years of the Second Plan or by about 6 percent on an annual average. Between 1956-57 and 1959-60, the percentage increase in deposit money was almost the same as that of currency with the public, the expansion in the two components being respectively 23.5 percent and 23.7 percent. With the progress of the Second Plan, the non-monetized sector was expected to decrease and with the opening of banking facilities in new areas, the scope of the organised banking sector was likely to expand. So far as the increased money circulation would find its way into the banking system, the latter's credit-creating capacity would increase. To mop up this credit, variable Reserve Ratio was rightly thought to be an effective weapon. Accordingly, by the Reserve Bank of India (Amendment) Act of 1956, by section 42 of the Act, the Reserve Bank was empowered to vary the reserve requirement of scheduled banks within the range of 5 to 20 percent in respect of demand deposits and 2 to 8 percent in respect of time deposits. The Reserve Bank could also require the scheduled banks to maintain additional reserves in respect of any increase in deposits after a specified date up to 100 percent of such increases. The Reserve Bank, however, had no occasion to use this method until March, 1960.

The results of the credit squeeze of 1960 would show that the objective was not wholly fulfilled. While impounding the banks' deposits, the Reserve Bank kept wide open its loans window. This softened the impact of the squeeze as the commercial banks could easily replenish their reserves by borrowing heavily from the Reserve Bank against securities. The distinction made between demand and time deposits in respect of reserve requirement also seems to have been out of line with the Reserve Bank's determined effort to mop up the excess liquidity of the banking system. The provision of a smaller reserve against time deposits might induce the commercial banks to increase these deposits by offering higher

interest rates on such deposits. In so far as this could happen, the banks' credit-creating power could not be substantially curbed.

Coming to fiscal policy, it may be noted that the tax system in India does not seem to have been worked fully in conformity with the needs of a developing economy.

If the primary problem in a developing economy is to raise the saving/income ratio, the main task before the tax system should be to promote capital formation and to reduce extravagant consumption. To achieve capital formation at a higher rate it is necessary that taxation as a proportion of national income should rise as national income rises. But recent calculations would show that while individuals paying income tax increased their share of the national income from 4.77 percent in 1951-52 to 5.78 percent in 1959-60, the proportion of their income paid as tax actually declined from 16.9 percent to 13 percent during the same period.

There is evidence to show that while the proportion of duties on "wage goods" to total Central Excises has remained more or less stationary at about 40 percent, the same on "amenities and luxuries" has declined from 52 percent in 1948 to 27.2 percent in 1960-61. Thus, there is ample scope for reforms in both direct and indirect taxes so as to fulfil the objective of mobilising the surplus currently generated in the economy for purposes of economic development. All this inevitably italicises the essential unity of the bond between monetary and fiscal policies. If the two are not simultaneously operated in a properly integrated manner, none of them will yield the expected fruit.



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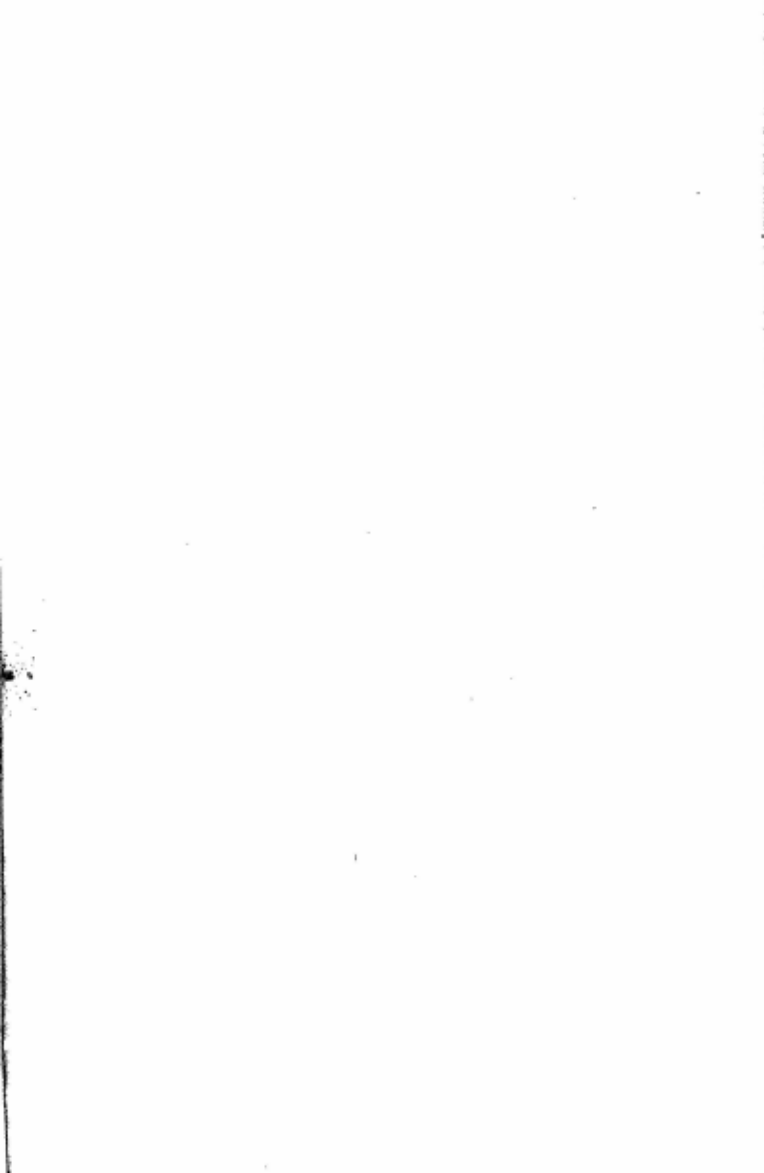
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