Development Without Instability

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THE publication early this week of the report* of the International Monetary Fund Mission which visited India last year will set at rest doubts about the functions it was expected to perforin. It was known that the IMF was interested in acquiring an intimate knowledge of the economic problems of its member-countries, but the extravagant welcome given to it by the Government of India had raised the suspicion that the latter was fishing for a certificate that it was keeping to the straight and narrow path in its economic policies. Though favourable in its appreciation of our financial policies, the report consists -essentially of an analysis of our monetary and fiscal problems, comprehensive and competent in the best traditions of the different international agencies.

Starting from the assumptions that it is necessary to protect the present standard of living of the lower income groups if not to raise it, and that it is essential to raise investment to the critical level necessary to bring about increasing production *per capita,* the Mission concludes that " the development of India must be carried out in an environment of economic stability" (p 4). It is to the. study of this problem of " Economic Development With Stability ", examined in the context of the investment programmes of the Five-Year Plan, that the report is devoted.

In line with the many international reports on different aspects of the problems of economic development, the main problem visualised in the study is that of inflation. It warns that " Inflation is a socially costly and economically wasteful means of increasing investments " (p 4), particularly since the problem is not to secure a short spurt of a relatively large amount of investment but a steady rise in investment, in many sectors of the economy and over a long period. However, " economic stability must not be confused with price rigidity" (P 5) since flexibility of prices is essential to induce the movement of real resources into those sectors which experience the greater growth. It is argued that even an upward movement in the general level of prices need not cause alarm provided it is functional in character, *ie,* it is a relatively small rise confined to a limited sector, and the rise comes to a halt when productive resources are moving to the expanding sector on the necessary scale.

Since they feel very rightly that the danger arising from the need to finance the Five-Year Plan is one of inflation, the authors are less concerned with the problem of preventing a swing in the other direction, although it appears that this is the immediate problem before the economy. They do not fail, however, to note the existence of the problem. It is pointed out that, " . . . excessive caution in credit policy may make it difficult for the economy to generate the resources it is capable of providing for development" (p 7). They are quite definite on this point and emphasise that, " . . . credit must be alert to ensure that a deficiency of money as distinguished from a deficiency of real resources does not further impede development " (P 43).

They have a pertinent remark to offer on the relation between real and money incomes, and how this determines the conditions under which economic development takes place. As the economy of India develops, a gradual increase in money supply is essential. " The increase in money supply that will be necessary," the report asserts, " is likely to be not less than in proportion to the increase in production . . ." (p 43). Contrast this with the Planning Commission's statement that, ". . . the accent in these first few years of development has to be on mobilisation of idle man-power with as little increase in money incomes as possible . . . ", so that it wants to ensure that money incomes do not rise with rising real incomes. The Mission appears to support indirectly the statement made in this journal *(The Role of Demand,* January 26, 1954) that " the immediate need is to ensure an increase in money incomes even greater than that in real income in order to ensure that the increase in real income in fact materialises".

While this statement referred to the immediate situation, one of lack of money demand due to deflation, the Mission recognises also the need for an increase in money supply more than proportional to increase in production to prevent deflation under certain circumstances.' This may be necessary, " . . . if industry, commerce and even agricultural production for the market gains in importance relative to agricultural production for the village community." The Mission is referring here to the monetisation of the economy, a subject on which little information is available at present, but which can certainly be of great significance.

The incorrect analysis of the Planning , Commission may have been due to its failure to realise that the " test of inflation is not whether prices now are higher than they formerly were, and certainly not whether they are higher than in the pre-war years. The test of inflation is whether aggregate demand exceeds the value of output at. current prices. Inflation is indicated by prices that are rising in the present, not by prices that have risen in the past" (p 9). On this basis, the Mission concludes that inflationary pressure does not exist in the economy since liquid resources have been mainly absorbed. This analysis itself is a valuable contribution to a study of the monetary situation in the country.

In this connection, the authors of the report have made the valuable suggestion that " the index of prices of goods produced and consumed domestically and which would be free as far as possible from the direct effects of external fluctuations" (p 9) should be constructed as this would be a valuable, guide to the operation of internal monetary and fiscal policies. In this way, while not disregarding international factors in the framing of policy, it would be possible to isolate them and then see them in the right perspective. They also suggest that indices should have a post-war base year, preferably 1948, so that they may not mislead.

* *Economic Development With Stability*—A Report to the Government of India by A Mission of the International Monetary Fund. E M Bernstein, Richard Goode, Morris Friedberg, and I G Patel. Ministry of Finance, Government of India. Price Rs 2/8.

The outstanding features of the report are the careful analysis of the international payments position and the estimates of financial resources as a preliminary to the examination of the problem of deficit financing. While noting the improvement in our exchange position during the last few years, the need for caution is stressed. Attention is drawn to the fact that India's present exports are concentrated on too limited a group of goods, "some,.of which are highly sensitive to business conditions abroad and whose prices fluctuate rather widely" (p 26). Also, the demand for imports is likely to increase as a result of the planned increase in national income. There is, therefore, likely to be heavy pressure on the payments position in the future. Though foreign aid may help in meeting this difficulty, " where the problem is one of inadequacy of resources, it cannot be met simply by providing foreign loans or grants to pay for imported equipment" (p 77).

The examination of the financial estimates, " indicates that resources will not be available for carrying out the investment contemplated under the Five-Year Plan" (p 41). The Mission finds that no favourable conclusion with regard to the remaining three years of the Plan can be drawn from the conditions that prevailed during the first two years. An unusual amount of resources was available during those years for carrying out the Plan, because of large extraordinary or non-recurrent revenue in the form of export duties and collection of income-tax arrears. Besides, there were the resources represented by the US Wheat Loan. Though it does not draw that conclusion, there is much to be said for the argument that this fact together with the relatively slow pace of public investment has, in fact, contributed to the deflation that has overtaken the country.

In any case, there will be a paucity of resources during the next few years. It is in order to meet this problem that the Mission considers the question of deficit financing. " There are only two ways in which the money supply can be increased: by the acquisition of foreign exchange assets and by the creation of credit." From its subsequent discussion it is apparent that it includes both currency and bank credit in credit. In its use of the phrase, " deficit financing," however, it keeps to the sense in which it is used in India, *ie,* financing of a deficit in the budget of the Government through the drawing down of its cash balances and borrowing from the Reserve Bank of India.

While admitting that there is no formula for determining the amount of deficit financing that may properly be undertaken, it concludes that, *"As a minimum,* . . . the use of cash balances by the Government of India and the creation of Reserve Bank credit and commercial bank credit, for the public and the Government, should be undertaken equivalent to the further use of sterling resources" (p 46) (italics mine). The Mission suggests that deficit financing or commercial credit for the private sector are only alternative methods of restoring the money supply which is likely to contract consequent on the drawing down of sterling reserves but that the extent to which the Government on the one hand and businessmen on the other are enabled to utilise the resources so created, depends upon the extent to which either method is utilised for the purpose. So that deficit financing " is but one aspect of credit policy, and it is only on the whole range of credit policy that a judgment can be made" (p 47).

Here, the Mission attempts a rough estimate. " The money supply at the end of March 1953 was Rs 18.5 billion. Disregarding adventitious factors, it is probable that, if the economy develops as foreseen by the Five-Year Plan, an appropriate money supply for India by March 1956 (the close of the Plan) would be (lose to Rs 19.5 billion. If the drawing down of sterling balances in this three-year period should amount to Rs 2 billion, it would be possible to reduce the cash balances of the Government of India and increase Reserve Rank and commercial bank credit by a total of close to Rs 3 billion " (p 48).

This, of course, depends upon the actual increase in production that takes place during the period of the Plan. Not all of the appropriate amount of increase in the money supply can be used for deficit financing, since adjustment would have to be made for expansion in commercial credit. The Mission suggests that beyond the equivalent of the drawing down of sterling balances, " an uncertain fraction, perhaps about one half, of the net increase in the money supply can be used for deficit financing without serious risk of inflation." The limit to deficit financing on this basis would be about Rs 250 crores. But the Mission feels that this much might not necessarily be desirable as the private sector should not be deprived of resources for which its needs might be as great.

The most controversial part of the report will be the remarks on controls. The Mission feels that these are undesirable, except to the extent absolutely necessary for defending the consumption of low income earners. It argues that if there are inflationary forces at work controls will not prove adequate for the purpose and otherwise they result in an undesirable diversion of economic resources. Issues are sure to be joined with the Mission on this question by many strong supporters of controls in the country.

There are many features of interest in the report, only some of which have been discussed above. The most interesting chapter is the analysis of the balance of payments in relation to the Plan. Important suggestions for augmentation of Government revenue are also made.

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