

INFLATION AND ITS REMEDIES IN INDIA'S PLANNED ECONOMY*

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This paper intends to examine in what way and to what extent inflation which is generated by the process of development may be held in check by monetary and fiscal policies with special reference to the Indian experiment of planned development of her economy. But, since 'the great controversy' on inflation as an instrument or otherwise of economic development has centred round the experience of Latin American countries [1] [2], a short résumé of the controversy is also given.

It is now a commonplace in development literature that one of the important limiting factors in the rapid industrialization of an underdeveloped economy is the lack of capital resources, and the argument that a vicious circle constricts underdeveloped countries in their attempts to raise their low level of capital [3] [4]. Both the demand for and the supply of capital in a backward economy are under the sway of the vicious circle. This is the result of low productivity in agriculture and manufacturing, which results in low national income which implies a negligible rate of saving and capital formation: low rate of capital formation means low productivity and low national income. This vicious circle inhibits both saving and investment.

This vicious circle has to be broken at the point of low capital formation, as the rate of development is a function of the proportion of income saved and invested, and also of the coefficient of productivity [5]. Productivity itself largely depends upon investment. Further, the crucial role of investment can be viewed from yet another angle: if we postulate the existence of a large volume of disguised unemployment in underdeveloped countries, as has been testified to by many writers, it is seen that this is largely, if not solely, due to the lack of complementary capital and technical resources. Moreover, it has been argued that investment is also a "pace-setter for additional investment" [6], apart from its income-generating and capacity-creating functions. Investment is thus a prime factor in the process of development.

In most underdeveloped countries investment as a fraction of their GNP is extremely low, something like a little over 5 per cent or so. It is obvious that this level is much below the critical minimum level [7] or the point of 'take-off' [8] or the Big Push or Pull [9] necessary to rescue these economies from the morass of poverty, hunger, and disease to which they seem to be

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condemned even at this period of history [10]. Therefore, unless induced investment reaches a certain definite level—12 to 16 per cent—an underdeveloped economy will have a tendency to slip back to the vicious circle of poverty. To reach this level of investment a commensurate percentage of savings must be generated in the economy. But there are certain 'institutional' rigidities which inhibit the generation of this volume of savings through voluntary efforts. The relatively low income per capita, the high rate of growth of population, and the powerful stimuli to consume imparted by the more advanced countries through the 'international demonstration effect,' are some of the factors which prevent an economically backward country voluntarily to reach a higher level of saving. The potential margin of saving has, therefore, to be tapped by some form of compulsion [11].

Can this compulsory saving be generated through inflation? "The manner in which inflation is able to bring about a rise in saving is well known. In some circumstances, a money illusion can be created so that even when individual money incomes are not rising (no more than in proportion to prices) a large proportion of current money and therefore of real income is saved. But money illusion can hardly be relied upon except in the early stages of inflation, and it may quickly disappear once people realize that their real income is remaining unchanged" [12, p. 14]. Theory holds that if inflation is to be able to force a higher level of saving, there must be a shift in income away from people who tend to save a small or negligible proportion of their incomes to people who tend to save a large proportion. This implies that the rise in money incomes of the former group must be less than in proportion to the rise in prices, while those of the latter must rise in greater proportion. The group of low savers is now forced to reduce their consumption by as much as their real income has fallen; while even if the consumption of the high savers rises, it is not likely to rise by as much as the decline in consumption of the low savers. The aggregate level of consumption then falls, and resources are released to satisfy the investment demand.

Earl J. Hamilton in a series of studies has striven to prove that this discrepancy in real income between the two groups of savers—wage earners and profit receivers—during the period of what he calls the Price Revolution (the 16th and the 17th centuries) has been one of the major contributory causes for the economic development of Western Europe [13]. This view, however, has been challenged by others who contend that "there is no correlation either between the degree of price inflation and the degree of profit inflation, or between the rates of profit inflation and the apparent rates of industrial growth" [14; p. 444]. Being not sufficiently equipped with the type of historical knowledge necessary to make any meaningful comment on this dispute, I can only say like Sir Roger de Coverley that "much may be said on both sides."

Hamilton's studies had, however, led him to believe that in the light of historical experience the present day underdeveloped countries would be well

advised to seek in inflation a very potent instrument for development. But in a recent study G. S. Dorrance suggests that "inflation is likely to evoke forces which both diminish the resources available for development and reduce the true effectiveness of those funds which continue to flow investment. Saving is likely to be lower than under stable monetary conditions and to take forms which lead to a lessening of the adaptability of the economy and to a lessening of the forces of economic criteria in the choice of investment" [15, p. 16]. This view represents an aspect of what has come to be known as the 'monetarist' view in the debate on inflation in the Latin American countries.

The monetarist position stems from the fact that in most countries of Latin America budgets are chronically unbalanced, partly because of the failure to collect taxes that are legally due, and partly because of the use of public money in ways which enrich or strengthen the leading politicians. Bank credit has grown rapidly, but it is generally used for the construction of luxury apartments and houses rather than for the building up of badly needed economic overheads or industries. This has led to the view among outside economists and officials of the International Monetary Fund that the Latin American countries, especially their Governments, do not show any financial responsibility or prudence. As a consequence, when the Latin American countries approach the IMF for help in meeting their foreign exchange obligations the Fund insists that these Governments balance their budgets, stop the expansion of credit, establish a single exchange rate, and finally that these commitments be formalized in a 'letter of intent' before the Fund gives any accommodation.

As against this 'monetarist' position the 'structuralist school' rejects the contention that inflation is the result of "irresponsible" political acts, but that its causes are to be sought in the very structure of an underdeveloped economy in the process of development. The 'school' maintains that today the export markets of Latin American countries are chronically depressed, and therefore, economic development has to be increasingly directed to satisfying the needs of the domestic markets. Moreover, when current unemployment is already high, the rate of growth of population very rapid, and expectations of a higher standard of living are great, economic development becomes an indispensable necessity. And when development begins, it starts with the creation of import-substituting industries, especially in the consumer-goods sector. Capital goods will have to be imported for the purpose, which implies, in the absence of foreign capital loans and grants, that exports should expand. But exports cannot expand, firstly because they are mostly of agricultural and other primary products (mainly foodstuffs) which are both income and price inelastic in demand; and secondly because of rising income, domestic demand for these products increases. In addition, due to the paucity of skilled labour or cheap capital or efficient managerial personnel, the cost of home-manufactured import-substitutes (and hence their prices) tend to be higher than the price of the replaced imported items. There are other

structural difficulties also, such as the inability of the transport and electricity industries to bear the burden placed upon them by the requirements of development; the unequal land distribution and the antiquated system of land tenure which prevent food production from responding to increased demand, and thus helping to push up its price, which thus contributes to inflation in these countries. The thesis of the structuralists is not, therefore, that inflation helps growth, but that there are structural conditions helping inflation to develop when exports of primary products are not rising as fast as the conditions of development require them [1].

Against the background of these considerations, the problem of inflation in the context of India's planned development and the monetary and fiscal measures employed to mitigate its severity are considered in the following paragraphs. It may be remarked, however, that inflation in India has not been of the chronic variety or of the magnitude experienced by some of the Latin American countries.

If we are to be guided by the structuralist view of inflation in a developing country, India exhibits many of the institutional features which would inevitably generate inflation. She is predominantly agricultural, and her exports are more or less stagnant, unable to meet the rising cost of development. Her marginal rate of saving is far below what had been expected [16]. Her social institutions and cultural heritage are such as to be detrimental to development. In short, she has most of the institutional and behavioural characteristics that writers on economic development attribute to what they term "a traditional society" [17]. And yet the inflationary tendencies generated during the course of her development have been held in check through the means of both monetary and fiscal policies supplemented by physical controls and with the help of external aid.

In the matter of evolving a technique of monetary management to suit the requirements of development, the Reserve Bank of India concentrated mainly at first on ways of financing agriculture and small-scale industries, and diverting bank credit through a policy of selective control to channels approved by and desirable in the context of the Plans. The agricultural credit department of the Reserve Bank of India, which until 1953 was mainly concerned with research, was now required to be active in the matter of providing short-term and long-term credit to agriculture through the Land Mortgage Banks, Cooperative Societies, and the State Bank of India.

But it is in the context of deficit financing for development that monetary policy as an aid to growth and stability becomes relevant. There was a serious legal limitation placed upon the capacity of the Reserve Bank to expand money supply to aid the Government in its attempts to finance development. The original Act establishing the Bank (1935) required it to maintain not less than 40 per cent of the assets of the Issue Department of the Bank in the form of gold coin and gold bullion and foreign securities, the value of gold coin and bullion not being below Rs. 40 crores in value. This provision hindered the Bank from expanding its note issue unless it was

also able to expand its holdings of gold or foreign securities. And the problem became acute when the balance-of-payments difficulties, which had of course been always with India since the beginnings of her Plans, became so serious that they could be alleviated only by drawing down the gold and foreign securities of the Issue Department. So, through a series of amendments to the original Act culminating in that of November, 1957, the aggregate value of gold and foreign securities to be held in the Issue Department against currency was fixed at an *absolute* amount of not less than Rs. 200 crores, of which the value of gold was to be Rs. 115 crores (the original gold deposits with the bank worth Rs. 40 crores were now revalued to be Rs. 115 crores worth), and not as a *ratio* to the total currency issued. This transformed the method of note issue in the country and gave the Reserve Bank the necessary power to 'print' currency required to meet the development commitments of the Government. The Bank, however, was not very enthusiastic with the newly acquired powers, for it still gave primacy to its objective of stabilization.

To avert the possible danger of inflation, the Reserve Bank of India was empowered to vary the reserve requirements of the 'scheduled banks' within a wide range of 5 to 20 per cent in respect of demand liabilities and 2 to 8 per cent in respect of time liabilities. And one of the proposals made by Professor Lawrence Seltzer in respect of the excess reserves of the commercial banks of the United States as early as 1940, that it be decreed "that after a stated date all *increases* in the demand deposits of any bank be secured by a stated very high proportion of reserves—something like 50 and 100 per cent" [18, p. 29-30], was adopted as a policy measure. In addition to the very high primary reserves, the banks were required to maintain secondary reserves in respect of any increases in deposits with them after a specified period, and these secondary reserves to be maintained may even be required to be as much as 100 per cent of such increases in deposits [19, p. 344].

The anticipated deficit financing during the Second Plan period of Rs. 1200 crores was estimated to cause (by pessimists) a rise in the price level of the magnitude of 40 to 50 per cent or more over the Plan period, if appropriate steps were not taken to curb it [20, p. 287].

To meet such a contingency the Reserve Bank evolved at the beginning of the Second Plan a policy of quantitative and qualitative restriction on bank credit, for it had no control over the anticipated expansion of money supply through budget deficits. The policy of selective credit control became the chief instrument of monetary policy. The scheduled banks were directed to restrict their credit up to a certain specified amount against commodities like rice, wheat, cotton and others which were usually traded with the help of bank credit. The policy was pursued off and on throughout the period of the Second Plan and into that of the Third.

In addition to the directives for cautious lending policy, banks were also asked to reduce their continued reliance on the Reserve Bank for accommodation. Credit control measures were also supported by the use of the method of "moral suasion" through various conferences with the commercial banks.

Selective credit control was not meant, nor was it used as a substitute for a flexible interest rate policy but as its accompaniment. Actually interest rates were raised both before and after the selective credit control was put into operation. In short, the emphasis lay on both raising the cost and reducing the availability of credit.

As inflation once again seriously threatened the economy in the latter half of the fiscal year 1959-1960 and speculation became widespread both in the commodities and the securities markets, monetary policy came to be used even more aggressively: "selective control became less selective and more aggressive; 25 per cent of the additional deposits of the commercial banks were to be impounded with the Reserve Bank; the minimum margin requirements for bank advances against equity shares were raised to 50 per cent; a ceiling was imposed on the 'clean loans' of banks" [20, p.304].

The Chinese attack on India's northern borders in the fall of 1962 led to an increase in the price level. The possibility of further pressure on prices owing to the declaration of National Emergency led to a very stringent policy of credit restraint by the Reserve Bank of India. From the beginning of November, 1962, the Bank revised its system of lending rates, and for the first time regulated the availability of credit to banks by fixing a ceiling on such accommodation equal to the bank's average statutory reserves during the previous quarter. Borrowings up to 25 per cent of the statutory reserves were permitted at the Bank rate of 4 per cent, another 25 per cent at 5 per cent, and the balance at 6 per cent. These interest rates were again revised at the beginning of the 1963 calendar year. The Bank rate was raised to 4½ per cent. Banks were now permitted to borrow in each quarter a sum equal to 50 per cent of their average statutory reserves during the previous quarter at the Bank rate and the remaining 50 per cent at 6 per cent; any borrowing beyond this level was charged a higher rate. The average cost of borrowing by banks from the Reserve Bank during the first half of 1963 was 5.4 per cent as against 4.6 per cent during the corresponding half-year of 1962.

In line with the general quantitative controls, selective credit controls were also tightened up. The annual report of the Reserve Bank for the year 1963 declares that "the keynote of the Bank's credit policy has been to maintain both a general and selective restraint on credit and a pruning down of less essential demands through a combination of quantitative and qualitative measures."

An important development which had a profound effect not only on money conditions throughout the Second Plan period and well into the Third, but also on price level and on the effectiveness of the monetary policy during these times was the import of food and other agricultural commodities from the USA under PL 480. Before PL 480, food was imported whenever acute shortages appeared. The foreign exchange crisis of 1956 and 1957 resulted in the repletion of external resources to the point of irreducible minimum which left nothing for extraordinary food imports. The PL 480 imports came to

rescue the Second Plan schemes from being temporarily abandoned.

The real significance of these imports lay in the fact that no payment was made immediately in dollars. The rupee receipts were kept with the State Bank of India in the account of the US Government to be utilized partly to meet the expenses of the US Embassy in India, and the rest to be given in loan or grant to India in due course under specific agreements. Interest on these funds was calculated at a rate much lower than on loans secured from abroad with the exception of loans from the USSR [20, p. 289]. Finally, the US Government subsidized the export and shipping costs.

The impact of PL 480 imports on India's monetary and economic policy was immense: (i) it helped the supply side of the commodity market faced with a rapidly increasing demand; (ii) it caused the withdrawal of money supply at a time when large deficit financing was coming into operation; (iii) funds realized from the sale of the imports were not utilized for credit creation, although the commanding position of the State Bank of India increased; and (iv) it helped the State Bank to subscribe in a 'princely' way to the Government's borrowing programme. The most significant aspect in this regard had been that the Government was able to sell long-term securities, the sale of which had become almost impossible ever since Independence [20, p. 289]. The maturity pattern of the marketable securities was revised and the prices of long-term securities were made to rise. For the first time switching between short- and long-term securities was used as an instrument of monetary policy by the Reserve Bank, thus imparting greater flexibility to the entire debt management policy and creating healthy preference among bankers. Perhaps the most significant of all effects on price level was with respect to the timing of the agreement. It destroyed the speculators' expectation right from the beginning—which expectations and consequent actions had been (and to a certain extent, are even now) the most serious contributory causes of instability in the Indian economy.

Monetary measures by themselves would not be very effective in securing stability if massive additions to money supply are made in the context of development. Fiscal measures become imperative; and fiscal policy has been one of the major measures used for both the purposes of development and of stabilization in India. The period immediately following the achievement of Independence (1947) up to the inauguration of the First Plan (1951) saw two objectives which determined policy, viz., that of checking those inflationary conditions in the economy which were a legacy of the War, and stimulating private investment by suitable tax concessions and incentives [11, pp. 28-43].

In 1951, with the inauguration of the First Five-Year Plan and the structural change accompanying it, in so far as the sphere of economic activity was clearly demarcated into the public and private sectors, there also occurred a change in fiscal policy. Taxation was now to secure financial resources for the development of the public sector.

In India, however, the effectiveness of tax policy as an instrument for

mobilizing resources for development is limited to a large extent, owing to the "structural" aspects of the economy. First, there is the attitude and compliance of the people to taxation. This attitude for long has been one of hostility, nurtured in the pre-Independence era, and views taxation (symbolized in the salt tax of the British Period) as an instrument of political and economic domination over the country [11]. Secondly, there has been another kind of resistance to taxes due mainly to a lack of general education among the tax-payers, a very "parochial" sense of civic responsibility and the absence of a tangible 'quid pro quo.' Thirdly, there is the tacit moral approval of tax evasion and avoidance. Indeed, in his *Report on Indian Taxation* Kaldor remarked: "India like most Western countries has been in the grip of a vicious circle as far as progressive taxation is concerned—evasion and avoidance by cutting down potential revenue lead to higher nominal rates of taxation and this in turn to further evasion and avoidance and still higher rates. It is a vicious circle of charging more on less and less" [21, p.5]. Fourthly, the revenue derived from the comparatively small sphere of the corporate industrial and commercial sectors is not commensurate with the very high administrative expenses required for its collection. Fifthly, the existence of a non-monetized sector which was estimated by the Indian Taxation Enquiry Commission (1954) to be around 37 per cent of the total consumer expenditure in 1954 baffles all attempts at collection via the monetary and fiscal mechanism. And, finally, the most common cause of revenue loss is due to deficient assessment and collection. This is mainly the result of the comparative inefficiency of the administrative mechanism at the lower levels, due to the inexpert and frequently unreliable (because underpaid and over-worked) revenue officials.

The First Plan did not place too much reliance on increased taxation in providing resources for public investment: only 10 per cent of the total requirement was to be met out of savings from tax revenues [22, p.89]. Even this modest percentage lagged behind schedule, and external assistance did not come up to the expected magnitude. To the extent of these shortfalls the Government had to resort to deficit financing—a source not highly favoured in the original Plan. Thus in the last two years of the First Five-Year Plan money supply increased by Rs. 390 crores [23, p.138]. However, this increase in money supply only served to neutralize the post-Korean deflationary tendencies. Moreover, there was a considerable increase in agricultural output during this period. Consequently, despite deficit financing there was no increase in price level up to the end of the fourth year of the Plan. In its final year (1955-1956) agricultural production declined and prices showed an upward trend.

The Second Five-Year Plan (1956-1961) envisaged that, by means of a total development outlay over the five years of Rs. 4,800 crores in the Public Sector, national income could be increased by 25 per cent, and the rate of investment could be stepped up from about 7 per cent to 11 per cent of the national income. After exhausting the count of resources that could be

mobilized through budgetary sources (which includes borrowing from the public) and from external assistance, there still remained a gap of Rs. 1,600 crores to be bridged. It was decided to bridge this gap mainly through deficit financing worth Rs. 1,200 crores, and partly by additional taxation. Kaldor was invited to suggest methods of additional taxation. He suggested that it would simplify matters if a comprehensive and integrated taxation of incomes were to be devised, so that the 'vicious circle of charging more and more on less and less' could be broken and the loopholes of evasion and avoidance of taxes could be eliminated. He recommended the broadening of the tax base through the introduction of an annual tax on wealth, the taxation of capital gains, a general gift tax, and a personal expenditure tax; the last one in partial substitution of the super tax on income.

Many of Kaldor's proposals were adopted, so that from 1956 onwards direct taxation in India had undergone a radical change in its structure. But the expectations of mobilizing the targeted-for revenues through taxation and borrowing did not materialize, and greater emphasis was again placed on deficit financing, with the result that the price level went up appreciably. But, as pointed out earlier, the PL 480 imports saved the situation to a certain extent.

From the beginning of the Third Plan (1961-1966) India was faced with the dual problems of defence and development. Consequently, the total budgetary outlays of the Central and State Governments both on the revenue and capital accounts have gone up very substantially. Indeed, the performance of the Central Government in the field of additional taxation has already exceeded the five-year target laid down in the Plan (the target being Rs. 1,100 crores from additional taxation by the Central Government, and a total of Rs. 610 crores by the State Governments for a total outlay in the Public Sector of Rs. 7,500 crores). Over the entire Plan period, the total yield from the various measures of additional taxation undertaken by the Central Government during the first three years of the Third Five-Year Plan is expected to be around Rs. 1,900 crores. Additional taxation at the Centre and in the States during 1963-1964 (budget estimate) is expected to raise the ratio of Central and State tax revenues to national income from 9.6 per cent at the end of the Second Plan to over 13 per cent. This is a considerable achievement, and any further substantial expansion of tax receipts will only be possible on the basis of appreciable increase in production.

The taxation policy for the fiscal year 1963-1964 has a number of economic objectives. Firstly, the taxation programme has been designed to meet the heavy expenditure on defence and development. Secondly, taxes have been increased in order to keep down expenditure on items which have a large foreign exchange content and thereby minimize the strain on the balance of payments: a surcharge of 10 per cent was imposed on all imports, and duties on many items of consumer goods were enhanced. Thirdly, in an attempt to encourage import substitution, duties on machinery, iron and steel products, and motor vehicles parts have been raised. Lastly, there is the definite

attempt to mop up purchasing power and to restrict consumption so that inflationary pressures may be kept to the minimum.

It has been recognized that monetary and fiscal policies in isolation, or even in combination, would not be adequate in fighting inflation if it is very acute. Hence the Government has empowered itself with many legal measures to control capital issues for any purpose, to control the price, production, supply and distribution of certain specified articles.

Control over prices by directly fixing them was one of the earliest measures of control in India. This kind of price-fixing assumes that prices have an independent existence and that it is possible to determine the level at which they shall be fixed without controlling the price-determining forces. But history from very early days is a witness to the ineffectiveness of mere price-fixing without controlling supply and demand. Possibly one of the earliest experiments in maximum price-fixing was that of the Roman Emperor Diocletian in 301 A.D. And Jules Backman in his book *Government Price-Fixing* (N. Y., 1938, p. 155) quotes an interesting consequence of the Emperor's action: "the results of this edict according to the historian Lactantius showed the Emperor that no human will could prevail in matters like these against the force of circumstances. The dealers, required to sell at lower prices than they had paid, concealed their commodities; scarcity increased, street brawls followed in which blood was shed and it became necessary to let the law drop into disuse." Though street brawls and bloodshed may not normally occur nowadays because of price control, it may give rise to certain undesirable social consequences. When control over certain commodities is established it has an inevitable tendency to sprawl over the whole economy. But in a system of planned economy like that of India, price controls sometimes become imperative, because investment outlay outstrips the volume of current domestic savings and thereby is apt to generate inflationary pressures in the economy.

But it is evident that a (controlled) price policy would be successful when it is supported by regulatory measures over supply and demand. And the most effective way of controlling these factors is for the State itself to enter the market and carry out buying and selling operations on its own account. The India Government's grain procurement policy, stock-piling of food grains, certain operations of the State Trading Corporation of India—all bear witness to the practicality of this policy in India in curbing inflation and helping development.

The State in India has thus used its monetary, fiscal, and other powers to hold down inflation; and as long as agricultural production does not lag behind expectations (as it is doing now), or as long as 'buffer stocks' are available to offset inflation, economic development in India can proceed with the necessary minimum of inflation inevitable in and consistent with development.

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