PER JACOBSSON FOUNDATION, WASHINGTON, D.C.

The balance between monetary policy and other instruments of economic policy in a modern society.

THE BALANCE BETWEEN MONETARY POLICY AND OTHER INSTRUMENTS OF ECONOMIC POLICY IN A MODERN SOCIETY

TURES DELIVERED BY
. C. D. DESHMUKH
D
. ROBERT V. ROOSA

TOBER 1st 1965 WASHINGTON D. C.
DER THE SPONSORSHIP OF
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C. D. DESHMUKH and ROBERT V. ROOSA

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FOREWORD

This pamphlet contains the proceedings of the second programme organized under the aegis of The Per Jacobsson Foundation, which took place in Washington, D. C., on October 1st, 1965.

The Per Jacobsson Foundation was established in 1964 for the purpose of carrying forward the unique contributions which Per Jacobsson had made in the field of international monetary cooperation. Following his death in May, 1963, a group of his friends, led by a number of distinguished sponsors, joined in creating and financing this Foundation to sponsor lectures, seminars, and publications in this field.

The first lectures were given in Basle in November, 1964, by Maurice Frère of Belgium and Rodrigo Gómez of Mexico, on the subject "Economic Growth and Monetary Stability". These lectures were distributed widely in nine languages by the Foundation and through the cooperation of central banks, bankers' associations, and other groups.

The second meeting, of which this is the official record, was held in the West Auditorium of the Department of State. The principal speakers were Dr. C. D. Deshmukh of India and Mr. Robert V. Roosa of the United States. The over-all subject for their talks was "The Balance between Monetary Policy and Other Instruments of Economic Policy in a Modern Society". Opening statements were made by William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve System and Ambassador W. Randolph Burgess, President of the Foundation.

Included in these proceedings are not only the written statements presented to the meeting, but also a transcript of oral statements, and the questions asked and answers given by the speakers during the discussion period.

While the speakers all made their statements in English, the texts are being made available also in French and Spanish. Requests for extra copies of the proceedings may be addressed to

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Washington, D.C. 20431

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OPENING REMARKS

by

WILLIAM McCHESNEY MARTIN,
Chairman, Board of Governors of the Federal Reserve System

LADIES and Gentlemen: As with many occasions, there is an element of sadness in this occasion, because it reminds us that we have lost one of the world's great leaders in the field of international monetary economics. But, on the other hand, it is a very happy occasion, because I can think of no more appropriate way to memorialize the constructive work that Per Jacobsson has done through the years than the institution of The Per Jacobsson Foundation Lectures, which will aid all of us in continuing our interest and promoting research in the area of international monetary economics.

I think all of us in this room knew Per Jacobsson, and we know what a wonderful personality he was, quite apart from his intellectual capacity, for many times he befriended all of us.

It is a great privilege for me, as Chairman of the Board of Governors of the United States central banking system, to have this opportunity to welcome the Foundation to Washington.

It is a great privilege because Per Jacobsson had a great interest in central banking: he visited 10 to 12 Federal Reserve Banks during the time he was in this country, a record that I am sure a lot of people at the Board of Governors have not equalled. And I think that all of us recall his wit and his effervescent geniality, his joviality, his bouncing personality, and his willingness to take any amount of time and to be patient with all of us in trying to understand the intricacies of sound money and monetary policy.

I know that most of you have heard of one of his favorite puns, which he went around repeating with great joviality. When General MacArthur made his farewell speech and ended it by saying that "Old Soldiers never die, they just fade away," Jacobsson was bouncing around every place, saying that was a very good speech. "Do you know what happens to old bankers?" he would then ask. You would say, "No." And he would beam and say, "Old bankers never die, they just lose interest." One of the nice things about this lecture series is that as long as we continue the lectureship, both young bankers and old bankers will never lose interest in this area.

And I believe that the road which Per Jacobsson was traveling and which he traveled so wisely for all of us will be perpetuated.

It was through him that I first heard a phrase which I have seen several times since in publications, which I picked up at the fair in Lausanne several years ago, and which I like. He said, "Let us never forget that good money is coined freedom." That is a phrase worth considering and worth pondering.

It is a very great privilege for me to welcome The Per Jacobsson Foundation to Washington, and I know all of us are looking forward to the lectures which follow.

INTRODUCTORY REMARKS

by

W. RANDOLPH BURGESS
President, The Per Jacobsson Foundation

MR. MARTIN, Ladies and Gentlemen: I know that all of you would want me to express your appreciation to Mr. Martin for opening this meeting with those kind and glowing words that bring back to us the sense of the presence of Per Jacobsson.

I am particularly glad to have Governor Martin open this meeting, because I think there is a close connection between Bill Martin and monetary liquidity in the world.

That may seem a little far-fetched, but the point is this: for the 14 years that Mr. Martin has been at the head of our monetary system in this country, the world's liquidity has been increased because his very presence, his tact, and his wisdom have increased the world's faith in the dollar, and so has made people more willing to accept that dollar as a part of their reserves. So, Mr. Martin, you have helped, in yourself, to achieve some of the objects of the meeting that has just come to a close.

I think, ladies and gentlemen, that you would also want me, on your behalf, to thank the Secretary of State for making this room available; a lovely room, with chairs much more comfortable than those you have been sitting in all week. I can tell you that in this building there are many friends of The Per Jacobsson Foundation, friends who have interested themselves in what it has been trying to do.

The next thing I know you would want me to do is to convey your greetings and warm feeling of appreciation and friendship to Mrs. Jacobsson, who is here with her two daughters—Erin, Dr. Jucker-Fleetwood; and Birgit, Mrs. Björn Björnsson, and her husband. Their presence gives us a feeling that we are one family all together in this Foundation, people interested in just the things that Per followed and pursued so effectively in our behalf. Most of you *are* The Per Jacobsson Foundation, for it exists because of your help and your interest. Most of you are sponsors or contributors and have made the Foundation what it has become in the 18 months that it has been in existence.

Our group of people includes 47 of the central banks of the world, who have not only contributed to this enterprise, but have also helped in the distribution of our publications. You will be interested in knowing that the splendid lectures given last year by Governor Frère, who is here, and by Governor Gómez, whose charming wife is here also, were distributed all over the world. We ourselves printed 18,000 copies and sent them out in three languages throughout the world. Various central banks translated them into six more languages, so that they have had a wide circulation and have been the subject of a great deal of favorable comment.

Let me report also, since you are our shareholders, a word about our financial position. We now have capital of something over $380,000 and income of about $16,000. This is just enough to enable us each year to put on these lectures and to make our contribution to the cause of monetary stability and adaptability to new conditions.

So much for a brief report about the Foundation. Now we turn to the meeting today. I don't think the Chairman needs to take time to say very much because you have the program before you. This gives the topic, it gives a few words about the Foundation, and gives you also full details about the careers of the speakers.

One thing I do want to call to your attention is that each of these two speakers has had a background which includes three sorts of métier: they were each central bankers; they each served in Treasuries; they each served in academic fields. They are thus doers as well as teachers. That is one reason we are so glad to have them here and to listen to them.

So, without more ado, without taking your time to repeat what is in the program, I want to introduce to you the very distinguished central banker, Finance Minister, Vice Chancellor of the University of New Delhi, who was in 1950 Chairman of the Bank and Fund meeting in Paris, Dr. C. D. Deshmukh.

THE BALANCE BETWEEN MONETARY POLICY AND OTHER INSTRUMENTS OF ECONOMIC POLICY IN A DEVELOPING ECONOMY

Lecture by

C. D. DESHMUKH
Vice Chancellor, University of Delhi

FOR A central banker who has strayed from the profession into paths of dubious reputability, like politics, or uncertain status, like education, it is a high but somewhat disconcerting honour to be invited to talk on a topic like monetary policy. I am, however, touched by your choice of me for this excursion into a past whose interest was then abounding and is now made glamorous by the passage of time. I also welcome this opportunity of paying tribute to the most distinguished central banker in whose memory the host Foundation has been established. I met Per Jacobsson only once, for an all-too brief lunch hour in Zürich in October 1954, but I still recall the stimulating pleasantness of that contact. Per Jacobsson subsequently had a splendid vantage point from which to mould world opinion in monetary matters out of the profundity and maturity of his experience. He was the high priest of monetary policy and of economic growth with monetary stability, and it seems but appropriate that the initial lectures arranged by the Foundation should be on these and cognate topics, such as the one assigned to me.

Experience, 1943-56

I might begin by referring to my own personal experience as Governor of the Reserve Bank of India from 1943 to 1949 and as India's

Finance Minister and ex-officio member of Indian Planning Commission from 1950 to 1956. In these two capacities I was associated with monetary policy and the other instruments of economic management in two very disparate situations. In the Reserve Bank, I was closely involved in a type of economic management in which one had perforce to relegate monetary discipline to a secondary position. During wartime the regulation of money supply and credit on orthodox or classical lines is, as is well known, an impossibility. In India however, there was an element in the inevitable wartime inflationary situation which tempered the later impact of the inflationary trends in that India was paid in sterling for much she supplied for prosecuting the War. By the end of the War, India had a comfortable balance to her credit in the shape of sterling accumulated in London, despite the fact that the inflationary spiral had raised prices to three or four times their pre-war level, all sorts of goods (capital as well as consumer) were in short supply, and a great deal of foreign debt had been redeemed. The post-war independence and partition of India distorted the economy of the sub-continent for the time being; but perhaps the economic consequences would not have been so serious had the newly independent Government not made the grave error of lifting the wartime controls on food and cloth in 1947. (Indeed, in the United States also after the Second World War, there was a sharp rise of food prices, once controls were removed; this induced a rise of wages after June 1946 and raised aggregate demand in relation to available output and reinforced the inflationary situation.) On the insistent advice of the Reserve Bank of India controls were re-imposed a little later, but that bout of economic abandon contributed significantly, in my opinion, to the imbalance in the economy which finally led to the devaluation of the Indian rupee, together—a doubtful honour—with the currencies of some 30 other countries.

The period 1950 to 1956 was characterised by special measures to ensure that devaluation was not followed by a general rise in prices. The special situation created by the Korean War was dealt with by imposing heavy export duties, which resulted in a marked budget surplus. Expenditure, including a smaller defence budget, was restricted, until the promulgation of the First Five Year Plan in 1952 (with two out of five years already elapsed). Towards the end of 1951, while many physical controls were still in place, (although American wheat, under the first wheat-loan, had started to arrive), the bank rate was raised. The combination of deflationary measures produced what the money market called a slump in March 1951. A few more months' experience with the First Plan disclosed room for stretching it by about 25 per cent. The Plan was accordingly enlarged and was put through, with prices remaining stable. Thus development, although on a modest scale, was achieved together with price stability. Thanks to the opening up of channels of external assistance to cover about 16 per cent of the Plan, deficit finance was resorted to only to a modest extent—and proved harmless as prices and foreign exchange balances remained stable. The price situation was so deceptively easy, especially in regard to foodgrains and other food articles, like sugar, that physical controls were dismantled in 1952. The economy remained stable until March 1955, and the index of foodgrains and other wholesale prices was below the level of 1952-53, the base year.

But this comfortable state of affairs was not to last long. By April 1956, the Second, and a much larger, Plan had been adopted; and in a supplementary budget the annual plan was augmented considerably, with the assistance very largely of deficit finance. An imprudently heavy drain on sterling balances was created by unrestrained import licensing accompanied by uncontrolled credit creation by banks. To fill the monetary cup to the danger point, agricultural production sagged markedly below the levels attained in previous years. Since arrangements of the nature of U.S. Public Law 480 had not yet become a fixed feature of the economic landscape, about 3 million tons of food had to be purchased abroad, with consequently aggravated drain on the sterling balances.

India's Third Five Year Plan

This state of affairs continued and constituted the unfavorable milieu in which the current ill-fated Third Five Year Plan was born. Although there has been much stout-hearted recourse to fiscal measures (albeit with reluctance to touch politically critical areas, such as an enhanced tax on agricultural income on the part of the States), there has been a great deal of shilly-shallying and dodging in regard to re-introducing any rational system of physical controls, particularly in the face of inadequate improvement in the production of foodgrains. Side by side there has been signal failure, partly due to technical imperfections, in organizing family planning. The current rate of increase of the population has been around 2.50 against a little below 1.50 recorded in the

1951 census; therefore, it has been estimated on a conservative basis, that from the beginning of the Third Plan some 35 million, or about 8 per cent, have been added to the 1961 census population of 442 million. Even with increasing volumes of P.L. 480 foodgrain imports it has been impossible to feed this augmented population adequately. Restrictions on the movements of foodgrains, irrational and inconsistent with the concept of a unified nation, have led to wide disparities in the prices of foodgrains in the different States. Suitable incentives have yet to be found to induce the farmers, largely and growingly pursuing a subsistence economy, to produce more. Even a better than average foodgrain crop this year has failed to arrest the rising trend of foodgrain prices; and, structured as the Indian economy is, this has communicated its impulse to prices in other sectors, such as semi-manufactured and manufactured goods.

A complicated system of controls, permits and licensing in many sectors of the economy is about to be reinforced by more extensive controls of rationing and the rest. Whilst monetary policy as an instrument of control has been freely used, and both general and selective credit controls are being tried out in all sorts of combinations, the rates of public expenditure continue to be unduly high. A saving feature of the situation appears to be the realization of the dangers of deficit financing in such an inflationary situation; and much courage has been evident, at least as far as the Central Government is concerned, in resorting to fiscal measures to raise finance for discharging the State's dual responsibility of strengthening the country's defence force and at the same time endeavouring to complete the current Five Year Plan. It is against this background that the recent controversy about the size of the Fourth Plan has to be understood.

Moral of Indian experience

The moral of the Indian experience would seem to be that, with restraint in public expenditure and investment, an adequate rate of growth in production (especially of foodgrains) and appropriate fiscal policies (e.g., in regard to mopping up export incomes), monetary policy is called upon to play only a minor role and no heroic measures to control the creation of credit are called for. *Per contra,* when agricultural production fails to keep pace with demands from a fast-rising population and, at the same time, the rates of annual expenditure are stepped up to cope with the unnatural double burden of safeguarding the country's security while intensifying the efforts to promote economic growth, the price structure gets distorted and scarcities raise their heads in a growing number of sectors and become increasingly severe. In these latter set of circumstances, monetary policy has a more active role to play, but its application is erratic and uncertain and it has to be heavily supplemented by fiscal measures as well as by physical controls of a bewildering variety.

In the Indian context, the structure of international trade is an important determinant of the monetary solvency of the economy. With a growing escalation of domestic costs and prices, even if traditional exports are somewhat price-inelastic and partial industrialization enables some restraints to be imposed on imports, the import of individual raw materials seldom lends itself to constriction in a developing economy. This factor, together with the growing attraction of the domestic market to the producer, tends to diminish the favourable balance of trade, to create foreign exchange difficulties, and to lead to a lowering of the values of the local currency in the world's money markets.

In such an unhealthy situation, the reduction of public expenditure should be regarded as the most efficacious remedy. The proper management of controls, especially on foreign exchange, is crucial. There is reason to believe that the allocation of foreign exchange is ineffective and wrong-headed, making it possible for the unprincipled to cheat the authorities and to misuse the so-called export incentives. Therefore, there is everything to be said for replacing cumbrous systems of control by more discriminating ones; providing greater freedom of economic development to the private sector; and retaining as few controls as are strictly necessary, so that they can be exercised more effectively in their less diffuse field. The cruel dilemma of a developing country is that its developmental needs are great but the capacity to fulfil them through competent political leadership, effective administrative machinery and a well-established banking system is very limited. Political pressures lead to the undertaking of plan tasks which look innocuous and even highly justifiable, but which with the available levels of administrative competence are incapable of implementation. The gap between aspiration and capacity is harder to bridge than that between targets and resources, as here is the one area where the import of competence is not permissible. Institutional set-ups, e.g., central banks, have to operate within technically restricted fields as well as with constraints on autonomy which would be far less severe in more sophisticated environments.

Experiences of developing economies

Developing economies—especially in Asia—are of different types, each with its special problems of economic management. My acquaintance with these problems is naturally less first hand in countries other than India. Nevertheless it seems worthwhile to set down a few findings, which would probably be accepted, to illustrate how difficulties arise in managing induced economic growth in circumstances somewhat different from those in India.

India's neighbor, *Ceylon,* has apparently found it difficult to reconcile its monetary policy with its fiscal policy. A balance between the two could obviously not be achieved if they operate in opposite directions. Ceylon's economy is, moreover, dominated by foreign trade, and it is not always possible for the Central Bank to offset completely internal instability created by large export fluctuations. Moreover, Ceylon's dependence on imports for essential consumer goods as well as for investment goods is so great that in times of exchange difficulties it is difficult to restrict imports beyond a point. Curbs on credit are either impracticable, e.g., in regard to financing exports, or ineffective, as when there is excess liquidity with commercial banks. As regards Government borrowing, statutory limits have had to be revised continually under pressure of budget deficits, especially during the last ten years. Excess money demand has given a stimulus to import, while export earnings have suffered owing to deterioration in the terms of trade. The foreign exchange situation has therefore been a cause of recurrent anxiety. Credit regulation has been tried, albeit spasmodically and ineffectively, by raising the bank rate, increasing marginal reserve requirements, and the like; but credit requirements of the Government as well as the public have over-run such restriction. The Central Bank has been instrumental in establishing specialised credit institutions (e.g., Development Finance Corporation for long-term credit to industry, a market for Government securities, refinancing facilities, a bankers' training institute), but the dominant feature of economic management appears to be a fiscal policy pulling in a contrary direction, so that success in developing a sound financial structure, so necessary to development, has been limited.

CORRIGENDUM

On page eleven, the first word on the third line:

for stability *read* instability

years the banks have been able to build up excess reserves, calling for a rise of cash reserve requirements by the Central Bank. Since about a moiety of the business of the Philippines banks consists of the financing of foreign trade, prescribing margin requirements on outstanding letters of credit is the most effective of the instruments used by the Central Bank. During recent years the Philippines economy has experienced inflationary pressures, which the Central Bank has sought to counter by raising the maximum interest rates the commercial banks can pay on deposits, and also by issuing Government securities at competitive rate of interest. With the monetary expansion not abating, other measures have been adopted, such as transferring Government time deposits of the commercial banks to the Central Bank as they matured, raising the reserve requirements against deposits and prescribing a lower global limit for the borrowing at any time by the commercial banks from the Central Bank.

In the non-monetary sector of economic policy, exchange and import controls have played a large part. In addition to rigorous licensing of imports, the Government enjoys discretionary power to sanction protection, has instituted a system of tax remissions as an incentive to indigenous industrial enterprise and wields various other discretionary powers in regard to the allocation of Japanese reparations, the natural resource concessions and the P.L. 480 commodities. Import control has involved very severe restrictions on imports of non-essentials, e.g., cash deposits of 2,000 per cent were required against these in 1957.

In the *Philippines* also, the 16 year old Central Bank seems to have had only limited success in countering external or internal monetary instability, because the main source of inflationary finance has been the Government itself. The Bank's measures of monetary control have affected—too imperfectly—the private sector of the economy. Government planning appears not to be influencing this sector to any great extent or in an organized manner. The Central Bank's moral suasion does not seem to have an effect on the commercial banks; and, as there is no bond market of any consequence, there is little scope for open market operations. The bank rate policy has not been used to any significant extent, half the banking system consisting of the Government-owned Philippines National Bank. The Central Bank has regulated excess reserves of commercial banks with some success; but in recent years the banks have been able to build up excess reserves, calling for a rise of cash reserve requirements by the Central Bank. Since about a moiety of the business of the Philippines banks consists of the financing of foreign trade, prescribing margin requirements on outstanding letters of credit is the most effective of the instruments used by the Central Bank. During recent years the Philippines economy has experienced inflationary pressures, which the Central Bank has sought to counter by raising the maximum interest rates the commercial banks can pay on deposits, and also by issuing Government securities at competitive rate of interest. With the monetary expansion not abating, other measures have been adopted, such as transferring Government time deposits of the commercial banks to the Central Bank as they matured, raising the reserve requirements against deposits and prescribing a lower global limit for the borrowing at any time by the commercial banks from the Central Bank.

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Thailand, in contrast to India, Ceylon and the Philippines, has achieved development with stability, involving a minimum use of monetary restraints or other controls; this has been possible because of a well-maintained current account surplus, reinforced by massive injection of foreign capital. There has been a close correspondence between the real gross national product and the quantity of money, which is determined in accordance with the rate of growth of the gross national product. The general price index has been fairly constant, probably owing to constancy in the average cost of producing goods and services. In such a setting monetary management has had a limited role to play; and in any case its impact is necessarily limited owing to a number of factors, such as the commercial banking system not reaching out into the countryside, the lack of an organized money market, the non-dependence of commercial banks on the Central Bank for the bulk of their operations, as they enjoy considerable borrowing facilities from banks abroad, and the more or less steady excess reserves which the commercial banks are able to maintain. Since up to 25 per cent of the reserves can be held in the form of Government securities after the passing of the Commercial Banking Act of 1962, the banks are increasingly putting their excess funds into Government securities.

There are general restrictions on lending beyond a certain ceiling to any one person, which induces banks to spread their risks. The Central Bank fixes the maximum and minimum rates chargeable for loans or payable for deposits. In recent years the commercial banks have borrowed from the Central Bank, but only up to about 10 percent of their total borrowings. Rediscounting of export bills is now increasingly practised; but some latitude in regard to prescribing the rediscount rate, with a view to encouraging the growth to a bill market, has somewhat impaired the power to control credit through the means of the rediscount rate. The economy of Thailand is, to sum up, in the happy position of not needing monetary restraints, which in any case would not have been effective if needed and instituted. Nature's bounty assisted by the foreigner has placed the Thai economy in a very comfortable position.

Experiences of developed countries

Some reference to what may be regarded as the typical situation in developed countries is appropriate at this point. The greater primacy of the money and bond markets, the universal spread of banking facilities, more immediate concern with trade cycles and recessions and lesser preoccupation with unemployment or underemployment, and absence of the need for concentrating on development, especially through State directed planning, are the main features. But it is worth noting that, even in such a beatific setting, experts and practitioners in economic management are by no means agreed on the precise role and functioning of monetary policy; and even in this sophisticated milieu, periodical warnings in regard to the perils of monetary and price instability are not felt to be out of place. The reason, of course, is that these developed economies are also apt to suffer from certain brands of inflation, which one may regard as the occupational disease of affluent societies. In this—what one may class the classical—setting, monetary policy has a relatively dominant and determinant role to play. To the old objectives of stability of the domestic price level, stability of the foreign exchange rate, and avoidance of slumps, recessions and more than marginal unemployment have recently been added two positive aims, e.g., maintenance of employment at a high and stable level and maintaining a high level of investment to promote economic growth.

The primacy of monetary and credit policy implies that the money supply of the community regulates the level of expenditure. Keynes argued that there is considerable elasticity in the demand for money. It has also been pointed out that the velocity of circulation of money is not determined by factors independent of the supply of money or the volume of payments, that the impact effect of any change in the money supply is not on the level of payments at all but on the velocity of circulation, and that considerable changes in the money supply in relation to the national income can take place without inducing spectacular changes in interest rates. It has been argued that investment is insensitive to changes in the interest rate. In this view a rise in interest rates may affect short-term investment, e.g., in inventories, and the effect would in any case be a temporary one, but it could not deal with inflationary pressures emanating from other sectors, e.g., insufficiency of savings in relation to investment in fixed capital, budget deficits or export surpluses. Only drastic and spectacular changes in interest rates could be expected for various reasons to exert any market effect on capital expenditure. But unstable interest rates would embarrass the Government, which usually holds large volumes of short-term bonded debt; such rates would also create an undesirable instability of bond prices, thus coming in the way of the effective functioning of the capital market, and also tend to raise the level of long-term interest rates. In this context the following findings of the Radcliffe Committee should be recalled: (a) Supply of money is not unimportant but money supply is only part of the wider structure of liquidity in the economy; (b) the decision to spend depends upon liquidity—not immediate access to money; (c) "during the last few years the volume of spending has greatly increased while the supply of money has hardly changed"; (d) "monetary measures operate upon total demand by means that disturb some institutions and some people more than others."

The desirability of trying to maintain price stability has also been questioned, as it is likely to inhibit economic growth. For weakly progressive economies a regime of stable prices might mean low profits and dampened down investment. Some economists have even held that the objective of stable prices or falling prices may well be regarded as a luxury which only fast-growing economies can afford. "High" or "low" prices do not matter. What matters is rapidly changing prices. It is held that imbalances are inherent in the growth process; the reflection of these imbalances will be changes in the parity of sectoral prices; "stability of prices" will be out of the question.

A view which has been set forth is that monetary and credit policies represent at best crude and blunt instruments for controlling inflationary and deflationary tendencies in the economy. There is no selectivity; they do not deal with vulnerable points; they disturb some institutions and some individuals more than others. They should therefore be employed only in circumstances in which, and to the extent to which, no superior instruments of control are available. Thus, where there is excessive pressure of demand, fiscal measures, more predictable and immediate in operation, would be preferable to monetary restraints. They have a more certain impact effect; this advantage is more precious, the more drastic the required change. Again, situations involving wage inflation not reflecting the general forces, e.g., excessive demand, making for rising prices, could probably call for more efficient production and greater technological advance. The process of wage inflation (rise in W/E, with W representing wages and E efficiency) causes an excess of aggregate money outlay over total available output. This may be due to food shortages as explained below.

Thus in developed countries also there appear to be various limitations to the effectiveness of monetary policy as an instrument of economic management. It might be added here, to complete the picture, that in totalitarian economies delicate instruments of monetary control are not needed at all, because of a system of rationing, allocations, quotas, turn-over taxes and the like. The control of demand does not pose a serious problem. Here the whole apparatus of planning is supply-oriented, concentrating as it does on the capacity-creating effect of investment and capital-output ratio. In this case the State adjusts consumption and investment directly on income and, through income, on consumption or demand.

Government role in economic activity

The modern society, if it is defined as an economically developed community commanding up to date techniques of production and endowed with scientific modes of living and thinking, can be found only in a relatively small part of the world so far as population is concerned. The much larger part of the world, i.e., the developing countries, is characterised by primitive modes of production and distribution and social and educational backwardness as well as political immaturity. The problems in the field of social and economic policies in the two categories of societies differ widely. It is necessary to make special mention of two important differentiating conditions under which the developing countries are striving to bring about their economic growth. For one thing, the present-day developing communities are not in the same type of social or technological milieu on the eve of their development as the new developed countries were in the past. For the latter, it was largely a question of fanning out into virgin territories, with no precedent or competition or even inhibition. Even their social philosophy was not at variance with their economic rationale so that the former did not act as a drag on their economic expansion. On the other hand the social and economic environment in which the present-day developing countries have initiated and are pursuing their programmes of development are vastly different. The logic of economic thinking, as also the policy instruments derived from it, need in consequence to be different from those in vogue in the eighteenth and nineteenth centuries. Besides, very few of the developing countries are immune to outside forces; their population is open to the influences and impulses from the developed ones, with the result that the policy-makers in the developing countries have to bear in mind not only what the prevailing internal economic situation dictates but also the impact of what transpires in the world outside on the forces within.

Secondly, as noticed already, the nature of the economies of the developing countries is characterised by pronounced market imperfections. Furthermore, the markets for factors and products are imperfect and suffer from lack of mobility, governed as they are by inadequate social overhead investment. The distribution of income and property in these economies is highly skewed, which tends to distort the pattern of demand for both consumption and investment, so that the prevailing prices do not always provide guidance for optimum allocation of resources.

The implication of all this is that the market mechanism guiding the allocation of productive resources, such as is characteristic of the developed countries, does not operate effectively in developing societies. This in turn calls for some conscious direction of economic resources through the States' participation in economic activity, with the object of maximising the rate of growth over time. The growth of the public sector in most of the developing countries is a reflection of this way of thinking. It is, however, worthwhile reminding oneself that the dominating role of the State in economic activity is not a unique feature of the developing countries. In fact, apart from totalitarian countries, many of the most mature developed economies, like Germany and Japan, also had a large degree of State sponsorship of economic activity at the "pre-take-off" stage of their economic development—a stage at which most of the developing economies are at present.

Objectives of economic policy

No discussion of appropriate policies can proceed without identification of the objectives of any policy that is proposed. Though the objectives of economic policy may vary from country to country and in the same country from time to time, there is a spectrum of objectives, unique in each case, that a country can adopt. The difficulty, however, lies not so much in achieving any one objective as in ensuring a consistency among the different objectives. In mature industrialised countries, there is usually an array of policy objectives, such as stability of the price level, stability of the exchange rate, maintenance of full employment or economic growth and so on. As so often happens, the achievement of any objective almost always leads to a conflict with the achievement of any or all of the other objectives. There is need, therefore, for sorting out which of these objectives should be considered to be of paramount importance or, alternatively, to search for an optimum objective-mix.

In the developing countries, where an abysmally low standard of consumption is a stark reality, economic growth with equitable distribution is necessarily at the centre of policy-making. In the process of achieving that objective, prices have to rise and in the process may reach undesirable heights or the external account may get into the red, as it often does, leading to pressure on the exchange rate. To a very limited extent, price rises may have to be tolerated as the concomitant of growth, provided, of course, they contribute to the furtherance of the main objective. Indeed, there were no few instances in history where stagnation was associated with price stability and economic growth with price instability and a deteriorating foreign exchange position. Thus, so long but only so long as the main goal predicated on a value premise is achieved, the other objectives could be subordinated to it.

Basic to the formulation of monetary and fiscal policy in the developing countries is the understanding of the nature of the process of economic growth. It is by now commonplace to attribute the severity of the economic problem of the underdeveloped countries to the low income-low investment vicious circle. It is, therefore, argued that a solution lies in raising these countries from a low level of investment of 4.5 per cent of national income to a high level of, say, 12 to 13 per cent. This is perhaps an over-simplified view of the process of growth, which turns out to be much too complicated in operational terms. But it does emphasise the need for a substantial and a rising rate of saving and investment which has to stem largely from internal efforts.

However, too much attention should not be focussed on investment in the aggregative sense as the sole generator of income and employment, as we are accustomed to do in the industrialised countries. In the developing countries the composition of investment is as important as total investment, if not more so. Investment in the context of economic development does not merely imply addition to fixed capital and inventories of any kind. There has to be investment in human capital also, like education, development of technical skill and provision of social overheads which are not governed by the profit motive alone, taken in the narrowest sense of the term. Also, owing to technological immaturity, gestation periods are apt to be longer.

The quantum and composition of aggregate investment is only one facet of the growth process; the other facet is represented by the total rate of saving and its pattern. There are inherent obstacles in the generation of saving in underdeveloped countries, such as the large extent of the non-monetised sector, inadequate institutional facilities, inefficient operation of the market mechanism and the misdirection of saving into channels not desirable from the viewpoint of income creation. It is thus the primary aim of economic policy to create the economic conditions that can give free play to the powerful forces making for a rising rate of saving. As in the case of the composition of investment, the pattern of saving also acquires a crucial significance. As emphasized earlier, the State has a positive role to play in the economic affairs of most of the developing countries. This suggests that the Government either through its fiscal policy or its monetary management would attempt to appropriate a certain slice of the income for financing investment. This can be achieved only if the pattern of saving is suitably modified through appropriate policy measures.

The regulation of the pattern of saving and investment is also essential on other considerations, which are intimately linked with the nature of the process of growth. Economic development implies certain structural adjustments so made that a flow of resources is diverted from the consumption goods sector to the investment goods sector. It has to be emphasised that such a transition is not smooth or frictionless even when the investment is financed by the currently available savings. The rate of capital formation, if it is to become self-cumulative, has to be substantially large, which means that a correspondingly smaller proportion of a rising output would be available for consumption. It is also necessary that the resources be drawn into new investment through appropriate price incentives. Apart from this, the process of economic development is subjected to the severe pressures that emanate from the lack of balance among the various sectors of the economy, even when the aggregate demand in general is not excessive in relation to the available resources. A glaring example of this is the lagging agricultural sector in most of the developing countries like India, Ceylon, Pakistan, the Philippines, Brazil, Argentina, etc. The impact of a rise in money incomes generated by new investment falls most heavily on wage goods which by and large are foodgrains, the income elasticity of demand for which is very high in most of the developing countries. When, thus, the supply of these wage goods does not rise with the rise in money incomes, the prices of these goods tend to increase. The upward change in prices of foodgrains, instead of engendering an increased marketed surplus, actually pares it down in the type of agrarian structure that prevails in the underdeveloped countries. The rise in food prices thus becomes cumulative. However, the rise in food prices does not remain confined to that sector for long. Since food forms a larger proportion of the expenditure of the wage earners, the wage rates in an expanding industrial sector tend to move up, thereby transmitting what is initially a sectoral imbalance to the general economy. This type of inflationary pressure which is a combination of a "demand-generated inflation of food prices with a cost-generated inflation of industrial prices" is one of the peculiar, and also curious, features of the economic development of the developing countries.

The imbalances in the development process are not confined merely to the domestic sector; they ramify, perhaps with greater vigour, throughout the external sector of the developing countries, i.e., the balance of payments. Structured as these countries are, domestic saving generated there does not tend to become a substitute for foreign exchange as in the case of more advanced countries with their diversified productive apparatus. This is because the internal productive mechanism with its lack of know-how and technical skill in these economies does not permit the acceleration of the manufacture of capital goods. A far more important factor making domestic saving a poor substitute for foreign exchange is the inherent difficulties faced in the promotion of their exports. Admittedly, quicker economic progress is dependent on the availability, either domestically or externally, of capital goods in adequate amount. Thus when the developing countries formulate their development plans, they assume a certain expansion of their exports to finance the imports of capital goods to support their programmes. It is, for example, estimated that if the underdeveloped countries grow at a rate of 5 per cent per annum—a target which the United Nations considered as a minimum—their exports have to grow by at least 10 per cent annually. But imports are often constricted in developing countries by the relatively sluggish growth of their exports which are mainly primary commodities with their well-understood handicaps. The main impediments to the growth of these exports lie in the internal cost and price structure of developing countries as between primary products and manufactured goods, which is allowed to be high in the case of the latter, in order to encourage domestic infant industry.

An alternative to export expansion is import substitution. Though this provides some scope initially, it also tends to run into heavy weather owing to the narrowness of the domestic market. Import substitution can be undertaken up to the point where the size of the domestic market can sustain it; but once that barrier is crossed, further import substitution tends to bring about an increase in import requirements relative to export capacities, either to maintain newly started industries at full capacity production or because of the emergence of new industries with a high import content. The balance of payments problem thus gets further aggravated.

The implications of these structural imbalances should be borne in mind in formulating the appropriate monetary and fiscal policies. The process of growth is, as stated earlier, rarely steady and frictionless even when *ex ante* total saving and *ex ante* total investment are matched. The sectoral maladjustments result in sectoral pressures which make the entire system a "disequilibrium system", to quote Professor Galbraith. It would be, therefore, misleading always to identify the inflationary pressures in the developing countries or their balance of payments problems with the general monetary inflation; nor could they be ascribed always to the inadequacy of saving. In other words, the "inflation barrier" and the "balance of payments barrier" both to some extent appear to be ineluctable in most of the developing countries.

Thus, the logic of the growth process, as referred to above, pinpoints the trinity of the tasks before the developing countries: first, regulation of the rate and pattern of saving; second, regulation of the rate and composition of investment; and third, attainment of a balance in the external account. The efficiency with which these three principal tasks are achieved and the success that would attend it would decide the balance that the authorities should seek to maintain in the developing countries among competing policy instruments.

Monetary policy in developing economies

In developing economies, the monetary authorities have to aid in the process of monetising the economy by the creation of money so that an efficient payments mechanism is available for guiding the flow of funds for stimulating investment and production.

The role of monetary policy hinges on two conditions prevalent in most of the developing countries. There is an excessive pressure of population on the land, leading to the creation of what is known as disguised unemployment. Now this supposedly redundant labour has a certain "saving potential", meaning thereby that it can contribute to new investment and output without reducing its consumption below the existing level. It is operationally feasible perhaps to utilise this labour for new investment and output, without materially raising its consumption above its existing level, by putting it on new jobs and paying it out of created money. Since it is assumed that the level of its consumption would not rise materially, new money so created would only help to actualise the saving potential associated with disguised unemployment and thus contribute to capital formation and create new productive capacity. Thus to a limited extent, money creation is the instrument to redistribute income in favor of the unemployed. However, appropriate fiscal measures have to devised for inducing the surpluses required from subsistence farming.

The generation of new money by the monetary authorities would also meet yet another requirement in an expanding economy. With the increase in per capita income, the demand for money as an asset also increases, so that a larger proportion of additional income is held in money form. In such a situation, creation of new money only provides a much desired outlet for fresh saving, which then becomes available for financing additional investment. It follows then that the monetary authorities in the developing countries can facilitate the growth process through increasing money to an extent even more than that of a rise in real national product. An adequate money supply is a *necessary,* although not a sufficient, condition for economic growth. This is, of course, the general guideline, and the actual decisions of the monetary authorities would vary with the kind of situation they are faced with. A monetary expansion larger than the rise in *real* national income would certainly culminate in a moderate price rise. So long as such a price rise raises profit-income relative to wage-income it might assist in raising the saving rate in the economy. More often than not, however, the price rise rarely remains steady; and it tends to escalate, thereby bringing down the saving rate eventually.

Monetary policy has an even more crucial role to play in aiding the institutionalisation of saving and investment in the developing countries. The pace of economic growth is determined by the accumulation and dispersion of financial assets, far and wide, among all layers of the economy. In the rudimentary stage of backward societies, investment decisions of any economic entity are limited to the savings of that entity. When, however, the process of economic transformation proceeds apace, the proportion of investment financed by internal savings tends to decline and it is increasingly substituted by borrowing in indirect form from net saving entities, leading to the simultaneous expansion of financial assets and liabilities. It is this process which requires an impetus through the establishment of financial intermediaries, both bank and non-bank, whose primary function is to issue debt of their own by obtaining surplus funds from the net saving units and lending them to the net investing units. The total debt accumulation through this sort of institutionalisation of saving and investment tends to increase faster in relation to both income and wealth than under self financing or direct financing. Accumulation of financial assets leads, by and by, to their diversification, with the growing preference of the new income earners for varied types of financial assets as an outlet for their savings. It is for this reason that the more advanced the economy is, the greater is the proportion of savings of its household sector in the shape of financial assets. The ratio of personal savings in financial assets to that of physical assets is close to 3:1 in the United States, and I would not be surprised if it is just the reverse in many of the developing countries, if Indian experience is any guide.

The accumulation of financial assets also ensures a wider and a more rational choice for savers and provides a more impersonal and efficient mechanism for allocation of investible resources. The variegated nature of assets, with a different degree of risk and reward attached to each, brings forth a larger amount of saving. Furthermore, the ownership of these assets helps to minimise if not obviate the uncertainty of earning income which prevails in the absence of owning any assets and, as a result, income earners are apt to save more, despite a low per capita income, than in a contrary situation. An efficient allocation of investible resources is assured because of the operation of the financial intermediaries which are guided by the simple and objective criterion of maximisation of profit. It is in this context that most of the central banks in the developing countries in Asia, Africa and Latin America have assumed in recent years important roles in initiating and developing financial institutions, lending both long and short, although such a policy is considered to be unorthodox and unconventional in the lexicon of traditional central banking.

Instruments of monetary policy

Having thus set out the broad framework for the operation of monetary policy in relation to economic development, it is necessary to turn, though briefly, to some of the instruments of monetary policy, such as the interest rate, open market operations or selective credit controls. Taking first perhaps the most important—and also the most controversial—weapon, the interest rate, one can judge its efficacy, in developing countries, essentially from two sides: the viewpoint of saving and the viewpoint of investment decisions.

Of the two, the impact on the decision to save or on the saving pattern is the more doubtful and uncertain. A rise in the interest rate will lower the price of a financial asset, e.g., bond or share, and the lesser capital outlay would leave a larger portion of income for individual consumption. On the other hand, the asset holder might decide to attain the former level of assets through increased saving. The evidence available from the saving behaviour in some of the underdeveloped countries, like India, Ceylon, the Philippines, etc., indicates, however, that as much as three-fourths of personal saving is in the form of insurance, housing and small business, none of which is directly governed by the consideration of the interest rate. Moreover, the liquidity-function is interest-inelastic to a considerable degree.

The impact of the interest rate on the decision to invest is important where the public sector occupies a commanding position, as in many of the developing countries. Investment in the public sector is predicated on certain assumptions relating to the strategy of growth, which in turn derives its justification from the application of social cost-benefit criteria. Having taken the decision on the ground of larger social and economic policy, it is not always possible for the Government in a developing country to vary the volume of public sector investment from time to time in response to variations in interest rates. Furthermore, if it is a party to interest rate manipulation, it would find itself in the anomalous position of deciding to raise the interest rate in order to limit investment and simultaneously of being concerned, as an investor, with how to react to the higher interest rates. This, however, is not to suggest that public sector investment should be totally immune to the impact of long-term rates. It is arguable that, with a rise in long-term interest rates, the pattern of public sector investment, though not its volume, might undergo a responsive change in favour of less capital intensive projects.

Of the other two instruments of monetary policy, viz., open market operations and selective credit controls, the former cannot be really classified as a pure instrument of monetary control as divorced from fiscal considerations. The purpose, nature and functions of open market operations in developing countries are totally different. Unlike the practice in vogue in developed countries with well-knit capital and money markets, open market operations are mainly used in the management of the public debt. The rationale for this is to be sought in the nature of the investment decisions and the character of capital and money markets. In countries with partial planning, the financing of public investment acquires crucial significance. Since borrowing from the public constitutes an important item in the pattern of financing, the Government is preoccupied with the creation of a suitable climate for smooth absorption of the sale of Government bonds by the public. Naturally, therefore, this concern hamstrings the use of open market operations as a technique of monetary control. Another reason is that the developing countries have a narrow market for Government securities, so that any change that emanates from open market operations is apt to result in disproportionately wide fluctuations in the prices of Government securities, without affecting significantly the cash base of commercial banks.

Turning now to selective credit controls in their impact on saving and investment, these controls as they are implemented, it has been generally admitted, are negative in their approach and doubtful in their impact, as it is almost impossible to ensure the end-use of credit flows so that only desirable forms of investment benefit. This is a general limitation even in the developed economies, like those of the United States and the United Kingdom. Experience in developing countries shows that such measures are at their maximum effectiveness when they are associated with a general restraint on credit, though this may sound paradoxical. Perhaps this limitation is not felt to the same extent in advanced countries where the emphasis is more on the volume of investment than on its composition as a regulator of income and employment, although the Radcliffe Committee held that, apart from special cases—such as hire-purchase control—general control of trade credit could not be recommended. But their very limitation renders selective credit controls futile in developing countries, where balanced sectoral investment acquires paramount significance for achieving rapid economic growth without inflationary pressures. It is this deficiency, more than anything else, which calls for the intervention of fiscal policy in the developing countries.

Can it be said that monetary policy would be more effective in maintaining a balance in the external account of the developing countries than in the domestic sphere? Perhaps not. While analysing the nature of the growth process, I mentioned at the outset that the pressure on the balance of payments of developing countries is not necessarily and always due to the excessive general monetary demand. It is more structural and is not to be explained in terms of general overvaluation of currency in most of the developing countries so that it can be cured by the obvious remedy of devaluation. It is more the overvaluation in terms of prices of manufactured goods that matters, and this is better countered through the fiscal measure of tax subsidy. Devaluation, on the contrary, would generate inflation in domestic costs and prices in the sector of primary products which would percolate, sooner or later, to the other sectors of the economy. The problem of the balance of payments thus, instead of being solved, would be accentuated, with deleterious impact on the rate of growth.

Moreover, there is another aspect of devaluation which cannot be ignored. A recourse to currency depreciation by any one developing country relying for its exports on primary commodities as an "open sesame" to boost exports would only harm the exports of its competitors which again are, by and large, developing countries. Unless they take retaliatory action in such an eventuality, devaluation by any one primary producing country would culminate, through the adverse change in their terms of trade, in impoverishing the entire group of developing countries while, at the same time, enriching the affluent manufacturing countries. Here again eclecticism is called for. The experience is that it is impossible to achieve selectivity through the operation of monetary policy, unless recourse is had to a device of dubious value, viz., multiple exchange rates, which is rightly frowned upon by the International Monetary Fund.

Instruments of fiscal policy

Fiscal policy is no substitute for monetary policy insofar as the enhancing of saving through the monetisation and institutionalisation of saving-investment is concerned. The real opportunities for the effective operation of fiscal policy are provided by the need of selectivity in the pattern of saving and investment and the inevitability of the

State initiated development programme. Moreover, the implications of fiscal policy are much wider than those of monetary policy inasmuch as the elimination of glaring inequalities in income and wealth is a usually accepted major social goal in the developing economies.

A high marginal rate of saving can be achieved through either diverting a larger proportion of national output towards saving or through (1) taxing the high income groups. Insofar as the high income earning classes would have saved in any case, taxation of their income may not contribute to increasing the flow of aggregate saving; but observation of the economic situation in the various Asian and Latin American countries shows that the affluent classes in these economies are often prone to indulge in conspicuous consumption. Apart from this, in economies where Government is a partner in economic activity, the diversion from private saving to public saving tends to become an important precondition. It is on both these counts that a steeply progressive taxation occupies pride of place in the fiscal programme of most of the developing countries. From Keynes' General Theory on, it has always been recognised that expenditures financed by progressive taxation (effecting a redistribution of income) may raise income and employment. More recently it has been empirically shown that an increase in tax-financed expenditure may be expansionist even though taxation has no redistributional effect on income. In other words, no economist believes that expansion should necessarily be deficit financed. The extent to which indirect taxation can be pushed, however, is limited. The point is soon reached when the price effects of such taxation tend to be analogous to the price effects of money creation.

However, the imposition of sharply graduated income taxation may not be sufficient for regulating the pattern of saving or raising the saving rate. Efficient collection of income taxes levied through an (2) adequate machinery of tax administration is often a desideratum in most of the developing countries. In such circumstances, the fiscal authorities think of some other fiscal device, such as the tax on wealth, which can curtail the spending power of the high-income classes.

The low level of per capita income in developing countries is often the reason for not resorting to indirect taxation as a method of raising aggregate savings. In a growing economy, the level of per capita income is always rising, which implies that the fiscal authorities should divert a part of the increased income to the fisc. The essentiality of this form (3) of taxation depends on two major considerations. Firstly, it holds in abeyance the pressure on the available supply of consumption goods, since the income elasticity of demand for imports in these countries is invariably very high. It also helps to maintain a balance between aggregate demand and supply in regard to the commodities in short supply, especially some essential consumption goods and the crucial kinds of investment goods.

Another fiscal instrument which has a growing potentiality as a generator of saving is profits of public enterprises. Not long ago, it was considered that the public enterprise should operate on a "no profit-no loss" basis. Insofar as the public sector investment of social overhead types is concerned, this rule may perhaps be appropriate because of the realisation of external economies which benefit the varied kinds of other industries. But elsewhere this policy is erroneous and, with the expansion of the public sector, the area of profit accumulation under the State should widen and, since profits are the main source of saving, public enterprises should be required to increase their profits through rational pricing policies.

It has to be remembered that the magnitude of tax yields by itself is no guarantee of the generation of saving. One comes across many a Government in developing countries frittering away their resources through inessential expenditure in a fit of euphoria generated by the inflow of taxes. This is a danger to be avoided, particularly when the managers of public finance, both politicians and administrators, lack the same stakes in running the public enterprises as the private owners of industry.

The distinctive character of fiscal policy stems from its influence on the pattern of investment. Taxation is a much more potent instrument than monetary policy in ensuring desirable types of investment and curbing the inessential ones. Through appropriate investment allowances, tax rebates, etc., the right kind of investment is encouraged and at the right place and time, and the wrong kind of investment is avoided. It is not, however, always clear what desirable or essential investment is. Moreover, the policy of taxation or subsidy is apt to be complicated and cumbersome at times, and as such its impact may be diffused and lost altogether. For these reasons, the structure of taxation should be simple and easily comprehensible to the investors, if the maximum benefit is to be derived.

While the efficacy of a fiscal instrument in controlling the volume and pattern of saving and investment is rarely in doubt in the context of developing countries, it is even more potent in offering a solution to the vexatious problem of achieving viability in the external payments accounts. The structural feature of the production apparatus in these economies is such that the exportable goods, particularly new manufactured goods, are always at a relative disadvantage in the international market vis-à-vis the identical export goods from the more developed countries, owing to the divergence between the marginal social cost and private social cost of producing new manufactures. Though here wages are low, labour productivity is even lower. Until this activity tends to become economical with an expanded scale of operation and the formation of skills, it needs to be nursed carefully. A proper regard for this factor in the formulation of a fiscal policy can overcome the handicap, e.g., through subsidisation of the production cost of goods to be exported. It is in recognition of this fact that the GATT has permitted such practices in respect of developing countries.

On the other hand, the same reasoning underlies the case for taxation of some other export commodities of traditional varieties, the foreign demand for which is insensitive to price changes. In that case, any reduction in prices of these goods would only help to turn the terms of trade against the exporting countries. Governments of these countries therefore may tax those commodities and thus protect their export earnings in terms of foreign currency. Alternatively, the same purpose is served by the regulation of trade in such commodities through the instrumentality of Marketing Boards as have been operating in many of the African countries. It is thus obvious that the disadvantages of the export goods are rectified more selectively through fiscal management involving tax or subsidy than through a monetary policy.

It is also more rewarding to use the fiscal instrument to regulate the amount of imports and its pattern. For one thing, the higher tariffs help to protect a domestic infant industry until its teething troubles are over. But far more significant are the implications of tariffs on imports for the choice of appropriate methods of production. It is essential that the developing countries import capital and intermediate types of goods on a large scale for supporting their investment programmes. All the same, the cost of such goods should not appear to be too low, as it would encourage the use of techniques of production with a higher degree of capital intensity, which is what imported capital goods imply; and in an economy with redundant labour supply, such techniques would only mean an inefficient use of available resources. But this can be rectified through imposition of high tariff duties on capital goods. Devaluation can also raise the value of capital goods but the superiority of a fiscal measure, viz., the import levy, lies in its selectivity. Import duties when applied to nonessential consumption and luxury goods have also the additional merit of enhancing the rate of saving, since the income saved through higher prices of imported goods would have been otherwise spent.

Physical controls

The optimal operation of fiscal and/or monetary policy is possible in an environment where the market is perfect, with a smooth flow of factors of production. A certain change in monetary and fiscal policies either raises the price incentive in the form of cost of investment or a consumption disincentive. But when prices remain immune to these influences, there is a case for some conscious direction of resources, not on the basis of ruling prices but on a broader political and social ideology. It is this point where physical controls discharge an important function in allocating resources in developing countries. Additionally, physical controls help to solve the basic problem of distributing scarce resources and attempting to maintain a balance between the various sectors of the economy. The impact of fiscal-monetary policy on the other hand is felt only at the second remove, that is to say, after the decisions to save and invest have already been taken. It is obvious that when the price mechanism fails to function in a desired fashion and the scarce factors and commodities have to be carefully conserved and deployed, physical controls suggest themselves as perhaps the most useful instrument of economic policy.

The sphere in which such controls operate at a high level of efficacy is in regard to the allocation of investible resources. Through an appropriate system of capital issues and licensing procedure, the State can directly and expeditiously allocate resources along lines which have a high priority in the growth programme. In most of the developing economies, there is a planning machinery of one kind or another which views the problem of growth in a certain long-range perspective and then chalks out a time path of growth, having regard to the various factors, economic, social and political. In such a scheme of things, licensing of investment or the direction of physical resources acquires a top priority not only from the point of view of conforming to desired growth paths but also that of avoiding waste of scarce resources.

The imposition of physical controls on imports is even more imperative. But the investment elasticity of demand, as also the income elasticity of demand for imports, in developing countries is very high, and hence it responds only slightly to the price factor. With their usually exiguous foreign exchange resources, therefore, these countries cannot take any risk in allowing the imports to be regulated by the price consideration alone; hence the inevitability of quantitative restrictions on imports in these countries.

Yet physical controls are not an unmixed blessing. On a larger theoretical plane, these controls may appear to be the most acceptable form of policy; but great difficulties are confronted in their day-to-day implementation. The subjective factors like human judgment and prejudices tend to be given greater weight than the objective factors of need and utility. Even a more severe limitation of physical controls is the one that arises from the shortage of administrative and managerial skill in the developing countries which makes for their inefficient administration. Further, there is a peculiar tendency born of human weaknesses which leads controls to beget controls. The Administrators are prone to believe that the solution for any new problem that they are confronted with is to be found in the institution of fresh controls. The logical consequence, then, is that the economic decisions are lost in the maze of irksome and irrational procedures and rules without any gain in the form of efficient allocation of resources.

Summary

Let me now briefly sum up. The nature of the economic problem in the developing countries is such that it can be tackled only through simultaneous adoption—and adaptation—of the monetary-fiscal policies and other instruments of economic policy, such as physical controls. There is no objective law which neatly demarcates the sphere of operation of each; in fact, the areas of their operations overlap and often conflict. It may, however, be argued that, while monetary policy is more useful in monetising and institutionalising the growth process, it is fiscal policy which succeeds in achieving a better balance among competing investment demands, regulating the pattern of saving and maintaining a viable external account. The physical direction of resources is at its best only at the margin, when the market imperfections do not permit the prevailing market prices to reflect real factor scarcities.

It is not, however, easy to generalise about the relative importance of these various instruments of economic policy. Every country in this respect, therefore, is *sui generis*. Broadly, it can be said that the choice among alternative policy instruments is governed more by administrative ability, institutional features of the economy and political sagacity. In a sense, this is an area more for an act of economic statesmanship than for the rumination of an economist or the caveats of the central banker. But economic statesmanship is a scarce commodity in developing countries in the prevailing environment of impatience, the glamour of power and warped judgment. All such handicaps imply a price to pay in the shape of slower progress if costly errors of judgment are to be avoided.

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MR. BURGESS: I can see that those last words that Dr. Deshmukh said find an echo in this audience. Let me express our appreciation to Dr. Deshmukh for this very thoroughgoing and careful analysis, which reflects his own experiences over the years, working particularly with developing countries.

I am sorry that the exigencies of time didn't make it possible for him to give you a fuller exposition. His paper is more complete. It is available in full here in the hall, and will be circulated by this organization. We shall get it out as promptly as we can for wide study, because I know that it has in it a great deal of material that has never been put together in this form before, recording the experience of India and other developing countries.

Now we turn to a representative of a developed country, where the problems are different and the points of view are, perhaps, also different. I am sure this will give us an interesting contrast—another development of the same broad principles.

There is one very delicate psychological situation in human life. When you have had a job and then you have a successor, to have an objective judgment about the performance of your successor is a very difficult feat. It is easy to think that your successor is good, but not quite as good as you were. One of the greatest satisfactions I have had in recent years is to have had two successors in my job in the Treasury of whom I have been very proud, because they have done their job so superbly. And the one who has done it most recently is Robert V. Roosa. You have his full biography in front of you. I won't read it to you, but give him all the time. Mr. Roosa.

THE PLACE OF MONETARY POLICY IN THE ECONOMIC POLICY IN THE UNITED STATES

Lecture by

ROBERT V. ROOSA
Partner, Brown Brothers Harriman & Co.

(Note: Mr. Roosa made an oral statement in which he incorporated, by reference, the written text which was distributed at the lectures. The text of the oral statement is given below. The text of the written statement follows immediately hereafter, beginning on page 40.)

I WANT to repeat again the mixed feelings of awe and of continuing responsibility that we all surely feel in meeting here to honor Per and to do what little we can to carry forward in whatever way we can the tradition and the spirit of creative monetary management which he epitomized.

He has done much to condition the thinking and the action in which any or all of us have participated. I think, as we reflect on the great range of wisdom and of case-hardened experience that Dr. Deshmukh has just presented, we can see therein much that is new, new in its thought and in its implications for us. He also exposed further many of the threads that we had begun to see and many of the visions that we at times thought we were dimly beginning to understand, through the wide-ranging and perceptive work that Per did for all of us. So that it is with a sense here of continuing in all humility that I turn from this scholarly presentation and try to say a few words about some aspects of monetary policy within the framework of economic policy, as seen from the United States.

One of the many of Per's frequent remarks which burned themselves into my consciousness was that we always had to remember—every central banker had to remember—that his job was not that of a completely free agent. No, instead he had to recognize that the central bank's function, at any stage in the evolution of his own economy and of the world economy, its task was to adapt to the broad aims of economic policy adopted by his own nation, by the community in which it was functioning.

And at the same time, Per would also stress, that, as central bankers it is our responsibility to remind the other arms of governmental policy —our colleagues anywhere in public life and our colleagues anywhere —that there will only be short survival for any effort in the field of economic policy which attempts to ignore, sidestep or displace the elements of monetary discipline.

The central bank is not wholly free to pursue an independent course. But on the other side, no arm of government is free to determine objectives and pursue them without regard for the ultimate necessities imposed by monetary discipline, as Per so broadly and so effectively interpreted that discipline for us.

And it is in this dual way that we have to interpret the experience of the developing countries, as Dr. Deshmukh has so excitingly and effectively presented it to us. And it seems to me that the comparisons are closer than the contrasts. When we turn from the lessons of India, as he has presented them to us so clearly, to those which I want to comment on only briefly, relating to the United States, I am not going to use the written text, in the hope that I can more quickly skim forward, so that there will be a few minutes left for the questions that I know you are eager to ask of him.

But in the review of American experience and its relevance to this same broad unfolding formation of monetary management in the context of governmental economic policy, the first point I would like to make is that the evolution still continues. It is my own biased view that the United States has in the last five or six years been itself passing through a phase of economic development which is completely unprecedented and which, in a way, could be said to extend beyond that which has been experienced by any other highly integrated, complex, industrialized society in the modern era. And, if I can spend a few minutes defending that proposition, I would like then to go on to suggest, as a second principal observation, that this has led the pattern in the evolution of monetary policy—within the framework of governmental policy in this country over recent years—to take a form which to many, conditioned in the experience of other countries and other stages, has seemed, if not unorthodox, at any rate adventurous, and perhaps to some irresponsible or careless.

I want to try to indicate why it is, at least as I have seen it from one little window, that the evolving new aspects of monetary policy in the United States, have, I think, significance for the long-run future of every country as it reaches the kind of complex interrelations among sectors and interdependence with other nations that I think has been represented in the experience in this country over these few recent years.

But then, having dealt briefly with those two broad matters, I want quickly and forcibly to recognize that there are some very profound problems and issues that arise out of this new stage in the nature of our problems, and in the way in which we deal with them. These issues are going to require careful and searching, probing thought and experimentation, and I am afraid I will only be able to hint at what I hope may be the lines along which some of them may be resolved. As has been true in all economic history, the real answers are clear only after the event.

Now, to turn to the nature of the process that has been evolving in this economy in these few recent years, I think its most striking and yet often least recognized characteristic is one that I hope it will continue to deserve for a few more years at least. It is the implication that has been conveyed for the nature of the economic process here by the fact that relative price stability has now been maintained—and I hold my breath when I say now, at least up until the last few weeks, and I trust that this will continue—that relative price stability has been maintained for a period of six, seven or eight years, if you wish to be generous in the indexes that you use.

And the most significant derived result has been that, in an atmosphere of price stability, we have at the same time generated flows of liquid savings which were, by any standard in the history of mankind, unprecedented, beyond all bounds.

We did, of course, derive these as a by-product of a remarkably expanding gross national product, but it is significant that in terms of those liquid savings ordinarily identified in our thinking as the sources of pressure on supply or the fulfillment of demand in the open capital market of a developed country, that these forms of liquid saving over the years from '60 to '64, increased by two-fifths while the gross national product increased by one-fifth. Both, of course, are striking figures.

But the fact is that available and freely usable liquid funds, diverted into the financial markets of the country, were increasing in relative terms twice as fast as the gross national product.

This itself is to me a new stage in the evolution of the highly developed modern economy. And, if I can skip over most of what I have tried to allude to in the written paper, I would just generalize by suggesting a few contrasts. And I would warn you that all these statements are gross oversimplifications. I realize that. I hope you will indulge me in it. But the comparison that I would make is between that development of greater savings in the United States and conditions still prevailing in most of the European countries and many of the other developed countries of the world—or rather, more nearly developed countries; we are none of us developed: their pattern in relative terms has been one of relatively high investment demand and relatively low savings availability. Whether the savings availability, statistically computed, was low or not, the channeling of available liquid funds into the free money market for market allocation within those economies has certainly been relatively low in contrast to the surging and still pent-up demand, reaching out on all sides in those same countries. As the European countries moved forward to fill in old ground, to reach out into new product territory, the propelling force of internally generated new investment has been the dominant influence; savings in relative terms, domestically, have been lagging, so that we have had high investment and low savings, to put this in my framework of gross oversimplification.

On the other side, in the less-developed countries, those where the development process is a major preoccupation, we have had low investment and low savings.

In the United States, in relative terms, our problem has brought us around the circle much closer to the problem that Dr. Deshmukh has been describing. Ours is the problem of low investment alongside high savings. The results of this, both in terms of such mirrors as the levels of interest rates and in terms of such more worldwide implications as the performance of our balance of payments, have been that the high volume of savings in relation—I am talking in relative terms, of course—to the relatively low pace of investment in the United States, has been a spilling outward of our savings in forms that for many years proved constructive and helpful to the expansion of an outer world beyond the United States, where, as you remember, I said investment was relatively low, low in the developing countries, low in the more developed countries.

There was a clear need, in the broadest economic terms, for this pattern of redistribution. There was a clear economic compulsion for it to occur so long as markets were in any sense relatively free and the United States was alone as an island of price stability, while expansion of various kinds in other parts of the world was rushing forward. The United States was the one country able to continue to generate savings on the massive scale that I have just described.

This may, as we look back on it 10, 20 years, 30 years from now, seem to have been a fortuitous combination of circumstances, and much of our current concern may seem to have been trivial. Nonetheless, those of us who lived through it know that many of the by-products, and certainly the balance-of-payments aspects, have been far from trivial.

But it has meant that the United States had to develop a new balance among instruments of economic policy. And so to comment very briefly on this second of my three major themes, what it meant was not that we could pursue, as one would expect in a low-investment economy, an aggressively easy monetary policy. Our balance of payments would not permit this. We had to find instead the answer in the stimulation of investment through raising the incentive horizon across the whole spectrum of investment decisions. We had then to turn experimentally to fiscal techniques, which, as they were developed, at times seemed to imply risks of fiscal irresponsibility, incurring conscious deficits, additionally enlarging possible future deficits, at times when the national government's accounts were still out of balance.

And yet the results thus far have certainly justified the kind of analysis on which this rested, although there has been less attention given to one other very significant implication of this analysis. This is that, while these differences in the pace of economic development were still going on, the route toward a more stable and sustainable equilibrium among the nations of the world, would probably include —once we were successful in the greater stimulation of investment demand—rising interest rates, as there was a greater absorption of our huge savings into domestic investment. But this would be the natural course of events. This would not have been an artificially induced or contrived influence on rates. To continue higher rates would only have been an unfortunate imitation in this environment of policies which were perfectly appropriate in other environments. Higher interest rates would be quite appropriate in the environments of the other developed countries, where investment was rising ahead of savings, where there had to be the kind of restraint that took the form of higher rates of interest and where it could be said, although no one can ever trace causation fully in these fields, that perhaps the fact of central bank restraint was in some part responsible for the higher level of these rates.

But our immense flow of savings was generated by our having achieved the condition toward which every country aims or tries to aspire to, that is, price stability. The high savings generated by price stability, giving us a volume of savings in excess of our going absorptive capacity, created balance of payments difficulties. But it was certainly true that the answer in this environment could not be—in the interests of every trading partner of the United Sates, as it would have been in our own interest—should not be to have imposed an artificial scarcity of funds by trying to absorb, to dissolve, to destroy those savings through a kind of brutal monetary policy which could never, in the face of this internal generation of mammoth savings, have reached effective margins.

No. The answer had to be found in generating the same influences for producing higher interest rates that are now producing them in Europe. It had to be the stimulation of demand, not the artificial contraction of savings. Nor would we want to get the answer through a resumption of price inflation in the United States, drying up the savings incentives which otherwise provide such an enormous sustained potential for ourselves and for the world. So we had then to find a new mix for this phase of US economic development between fiscal and monetary policy, and at the same time, as I tried to say at greater length in the paper, we had to find other uses for debt management; and we found a place as well for the use of guidelines in limiting outflows of capital. We also used guidelines to influence within reasonable bounds the settlements of wage decisions, to minimize within this continuing environment of price stability the risks that we would break the spell through sustained increases in wages that would exceed productivity.

Through all of this, the role of monetary policy has been indeed a different one. It certainly has not been widely understood. The best evidence of that is the frequently heard question: why doesn't the United States raise interest rates and solve the whole balance of payments problem? After all, Europe is prospering with high interest rates?

The answer, of course, is in the causation. We would like nothing better than those same high interest rates if they came from the side of demand for investment. But they have to come that way, not through an artificial constriction of the supply of funds, through an extinguishing of the savings which price stability was giving to us, and not to other countries.

So that we had to pioneer, and in the pioneering we also encountered new issues as well as a need for reaffirming certain principles which have been tested time and again in our past experience as we went through other phases in the evolution of our modern form of economic society. This brings me to my third main theme: a review of the issues raised by this new experience.

The first arises because for sometime there has been a kind of ready compatibility between monetary policy and promotive fiscal policy. This has been interpreted as an implication that monetary policy could at all times remain passive and relatively inoperative. That interpretation we must be certain to avoid. And as I tried to explain at much greater length in the paper, as we get closer to the real aim, as our success becomes greater, (as it currently is) in promoting the investment that we need to sustain these high, unprecedented growth rates in the gross national product, as we come closer to the time where investment demand produces higher interest rates, we have to be certain that we don't then confuse the natural process of causation with an injunction to the central bank to just then pump more liquidity into the system.

The liquidity that has come from the savings induced while price stability was retained was one thing. But the influence that would come from an artificial generation of central bank funds superimposed on the flow of savings, which would show itself in higher prices, would be just as wrong, in my judgment, as it would have been to have taken the opposite course, so often urged on us by many of you during the earlier period.

So that it is essential to reaffirm the need for an independent judgment and execution of policy in the monetary field by the Federal Reserve System. There will come a time—we may be approaching it now—when there will be risks of an apparent conflict rather than continuous harmonious coordination of monetary and fiscal policy. We may at some stage, having passed through the current phase, find the capacity to promote the rate of investment that will keep the economy again utilizing the higher savings that it now generates. We may, likely will soon, find ourselves in the position where the central bank must reassert again the same role as governor at the margin to see to it that none of this surging domestic demand breaks out into price increases which might jeopardize the real gains which we have enjoyed so much over these past years.

In this we will have to be carefully revising our policy aims. We are going to have to be continually reviewing the role of our various policy instruments, and we are going to have to be continually relying on all of the devices and procedures and understandings developed over recent years, to shore up the balance of payments implications of what is, in fact, in the terms in which I have described it, for the current phase, a fundamental disequilibrium between two stages in the evolution of relatively developed economies—a fundamental disequilibrium between the United States and Europe, one for which exchange rate adjustment would have only been a futile gesture of despair, whereas more fundamental correction had to come from the sustained generation of greater investment demand in the United States. The implementation of the techniques, with many imperfections and slippages and time lags, has thus far been reasonably effective. From now on it is going to be more difficult. We are re-entering the phase where our similarities may be closer to Europe than to the conditions that Dr. Deshmukh was describing in India. But the role of the central bank is going to be crucial in this phase, as it has been in Europe, through its own recent experience, and it is even possible, in my own view, within five years, that the positions of Europe and the United States may be reversed.

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The written text submitted by Mr. Roosa for his lecture on this subject follows.

Per Jacobsson often counselled his central banking friends never to forget that monetary policy was an aspect of a country's overall policy.[1] He meant this, it always seemed to me, as a two-sided proposition. One side was that monetary policy itself must be formulated with full regard for all other elements of public economic policy; it could not pursue separate objectives. The other side was that all public policy affecting economic affairs should conform to those essential elements of monetary discipline for which the central bank has become the recognized guardian in most modern economic societies of the western style—from Japan, to Latin America, to Scandinavia.

The balance between monetary and other policies will inevitably differ among countries, to be sure, and for any one country the appropriate "mix" among policies will vary with the phasing of its own cyclical fluctuations and the character of its own long-run development. But there are trends within these various patterns that have to be sorted out for critical appraisal, from time to time, to provide the basis that democratic societies need for reaffirming, or revising, or reforming their own uses of economic policy. No one could accomplish that sorting out and appraisal more perceptively and effectively than Per Jacobsson himself. It is most fitting that these lectures honoring his memory should be addressed to a task for which his own worldwide experience and his intuitive sense for the changing tides of world affairs fitted him so uniquely.

His example also gave another kind of guidance to those who might venture into the foothills of mountains that he would have conquered. For as he said, he found that he could most effectively "elucidate the role of money in a dynamic economy by reference to the concrete situations in which countries have found themselves in the past and at present." [2]

My own effort, accordingly, will center on the role of monetary policy, and more narrowly on the role of the central bank, as seen from and in relation to the United States over the past several years—though hopefully some of this experience may have some relevance elsewhere.

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[1] See, for example, Per Jacobsson, *Some Monetary Problems—International and National* (London, Oxford University Press, 1958), p. 13, note 1.

[2] Per Jacobsson, *International Monetary Problems, 1957-1963* (International Monetary Fund, Washington, D. C., 1964), p. 311. (A reprinting of the Arthur K. Salomon Lecture, delivered at New York University, February 19, 1963.)

This will lead me, first, to a few comments on the problems of the United States economy over recent years and some of their policy implications; next, to a description of some aspects of the new lines of policy that have evolved to meet these needs; and finally, to an appraisal of the significance of these changes for the future role and range of central banking in the United States. While this will inevitably also lead me to some comparisons with other countries, I should give fair warning in advance that my characterizations of them, as indeed of the United States as well, will be gross, though I hope not misleading, oversimplifications.

I. A New Stage in Economic Development

It is my parochial view that a new stage in the evolution of modern economic society was reached by the American economy toward the end of the decade of the fifties; that this required in the United States not an abandonment but an enlargement of many of the established doctrines of "classical" economics, including those relating to central banking and monetary policy; and that this underlying structural change within the United States coincided with equally profound but more familiar kinds of changes both in the other industrialized countries and in the less developed countries. The coincidence of these changes occurred in such a way as to exaggerate, at least thus far in the decade of the sixties, an apparent three-sided conflict among (1) the traditional formulas for monetary discipline, (2) the special responsibilities of the United States dollar as an international currency, and (3) the monetary policy appropriate to what is now being colloquially called "the new economics" in the United States.

What had happened was that the United States, by the end of the decade of the fifties—having avoided a postwar collapse of the 1929-1933 variety, having weathered a series of relatively mild recessions, and having enjoyed a remarkable postwar expansion—succeeded in achieving for the first time in the postwar period the price stability that represents the fulfillment of monetary discipline. Insofar as public economic policy had been responsible for these results, they were largely attributable to the central bank, though its action to be sure had been usually supported by the Executive Branch of the Government. Both sides of Per Jacobsson's injunction had apparently been fulfilled; there was a mutual reconciliation of policies by the central bank in the political administration.

But there was growing concern, most notably within the Federal Reserve itself, that central bank influence upon bank credit was being expected to do too much toward maintaining overall economic stability in the United States. And there was growing awareness of the latent potentials for other public action to remove obstacles and to stimulate the renewal of sustained economic progress. There was also growing alarm over the rise in the volume of unemployment that had occurred in spite of the economic expansion and the attainment of relative price stability, particularly in view of the propect that further additions to the labor force would be coming along at an annual rate of one million or more over the decade of the sixties. And dramatic events in the autumn of 1960 forcefully awakened the United States to the fact that, for the first time in generations, it had a serious balance of payments problem.

Moreover, the United States had also begun to experience a remarkable rise in savings brought about by rising incomes in an environment of price stability—increases that were in time to raise the annual gross savings of households and corporations by nearly two-fifths over the four years after 1960, while the gross national product would be rising by one-fifth. In effect, after a long period of relatively heavy investment and lagging savings, the United States had entered a new phase in which, in the relative magnitudes then prevailing, investment was comparatively low and savings were enlarging rapidly. These circumstances differed significantly in their policy implications from the conditions of the other industrialized countries which remained in their postwar posture of relatively high investment and low savings (with the disparity aggravated within many of them by the continuance of small and fragmented capital markets). The less developed countries rounded out the contrast. Where the United States had low investment and high savings, and the other industrialized countries had high investment and low savings, the less developed countries characteristically had both low investments and low savings, and were in continuing need of imported capital to spur their development programs.

It should not have been expected that countries in these three fundamentally different sets of conditions, all pursuing further expansion during their sixties, could achieve a viable equilibrium in the flows of payments among them by following identical policies. Yet the prevailing concepts of balance of payments adjustment, while making room for the special circumstances of the less developed countries, regarded all of the industrialized countries as alike. Actually, these concepts had been focussed mainly on the conditions affecting the flow of goods, usually assuming that proper domestic policies affecting these flows would cause capital flows among the industrialized countries to follow along as a passive balancing item. But such adjustment had always also presumed, in addition to free flows of capital, that there would be fluctuations up and down in wages, prices, employment and output to bring about balance among the payments of the industrialized countries. However, modern economic society is instead oriented toward limiting, even preventing, the downward side of such fluctuations. As a result, once current account convertibility was widely achieved by the end of 1958, much more of the actual burden of effecting balance came to be placed upon capital movements.

Most of the industrialized countries, recognizing the implications of this change, retained or broadened their own controls over capital outflows. Some, whose markets were fragmented or cartelized, could rely instead upon constraints or frictions within the structure of their capital markets to obstruct outflows that might have jeopardized their own balanced or surplus position. But the United States, committed to the general freeing of capital markets along with the freeing of trade, and conditioned to a position of dominant strength that had earlier been impervious to external strains, kept its highly efficient, competitive and diversified capital markets open—as the volume of internal savings began to grow faster than the domestic investment which could absorb them. As a result, outflows of United States financial capital were to become in effect, increasingly, year by year during the sixties, the active balancing item for the accounts of the rest of the Western world—providing in turn a large increase in foreign holdings of dollar balances, not only by banks and traders who needed them, but also by some central banks which were not always content to hold more of them.

The United States thus entered the decade of the sixties with a combination of opportunities, needs and problems that was unique in the evolution of a highly developed, industrialized modern economy. It had for the time achieved price stability. It had begun to realize the great gains in the efficient allocation of resources that price stability, if maintained, could bring to a mechanized, automated, highly competitive economy. But it had also begun to experience the domestic and international consequences of a slackening in the momentum of its own investment, while its savings rose to unprecedented volume. The challenge confronting the United States was to find a way, through the intermingled influences of public policy and private enterprise, to maintain price stability with all of its longer-range potentials for the sustained strength of the American economy, while at the same time promoting sustained growth, reducing unemployment, moderating cyclical fluctuations, and balancing its international accounts.

The United States had begun to wonder, too, by the beginning of the decade of the sixties, whether it might not soon become overextended in its international banking role. Just as it was to seek new support domestically from other elements of public policy for tasks which had fallen too heavily on the central bank alone, so, with respect to the services performed by the dollar for the rest of the world, perhaps the United States should begin to seek support from other industrialized countries that had reached new positions of strength both in their economic performance and in the size of their monetary reserves. So long as the United States balance of payments remained in serious deficit, however, there would always be room for doubt as to whether the United States was merely seeking temporary relief for its own position, rather than structural improvement over the long run for the international monetary system as a whole. The emphasis within the United States would have to be placed, therefore, on determined and lasting restoration of a strong balance of payments position, while financing the remaining deficits during the transition back to balance in ways that would not be disruptive to other countries around the world.

II. Evolving New Lines of Policy

So long as the self-propelling forces of expansion within the United States economy were very strong, inflationary pressure were endemic and public policy appropriately emphasized the limiting of cumulative excesses in order to hold the expansion within sustainable bounds. In the later fifties, however, just as the insidious influence of creeping inflation was for the first time being overcome, the upward drive of the economy lost momentum. Investment remained relatively unchanged from year to year. Each recession had left behind a higher level of unemployment. It became essential, therefore, to shift the emphasis of economic policy. Instead of the curbing of aggregate demand, which had initially helped to bring about the long-desired price stability, there would have to be new measures to stimulate increases in aggregate supply. That was the best way not only to sustain price stability but also to fulfill the nation's other commanding objectives of optimum employment and growth and a balanced payments relationship with other countries.

Moreover, not only American traditions but also the remarkable results of past performance required that any new measures minimize the direct intrusion of public policy into the details of the individual decisions made by households and businesses. This was no occasion for a turn to national economic planning. The American economy had long outdistanced all others in responding readily to the widely diversified and frequently changing tastes and the continually enlarging demands of the consumer. And a consumer oriented economy must, if it is to grow and flourish, rely upon the directing stimuli of the market to guide investment and output. Consequently, United States economic policy continued to be concentrated, as monetary policy traditionally has been, upon influencing the framework within which a vigorous market economy could flourish. This meant that, whatever the new methods of economic propulsion which might be found, they should exert their influence by widening the incentive horizons for individuals and for businesses. In addition, in accord with good Jacobssonian precepts, the essentials of monetary discipline also had to be maintained. That is, there would have to be an overall but permeating check upon any unsustainable expansion by the United States, at home or abroad.

In its effort to evoke the needed additional output, the United States might have initiated massive increases in Government spending for general purposes, or it might have encouraged large wage increases in excess of productivity to swell effective demand. But any approach that could gain its positive effects only through the possible impact of an increase in aggregate demand upon the expansion of production was incomplete. Its results might only have been the resumption of an upward spiralling of prices. In the United States economy of the early sixties, the crucial link in the causal chain was, it seemed, the decision to produce and, underlying that, the decision to invest. And if real production was to be enlarged on a sustainable basis, the producer had to have not only the prospect of added markets but also some lasting improvement in his own incentives. He needed the assurance that his own expansion would be welcome as a fulfillment of public policy.

What this meant was that unit costs must come down, not rise, if prices on the average were to remain relatively stable. It meant that any general increases in labor or other costs should fall within the scope permitted by rising real productivity, and that the return on capital should also rise correspondingly. It meant that the prime force for the foreseeable future would have to be the stimulation of improvements in productivity, and that would include the elimination of existing obstacles to greater productivity. The expansion produced by this course of action could then be expected in time to lead to increases in Government spending to meet the public requirements of a growing economy, and to provide the source for lasting increases in real wages.

This was the diagnosis for which a new public policy had to be prescribed. The traditional stimulus for promoting business investment would have been a substantial enlargement of central bank credit and a general easing of the credit and capital markets. But the newly enlarged volume of savings was already at work, keeping capital readily available. Continuation of an easy money policy by the central bank, though perhaps useful in a supporting role, could not be the new primary force that was needed if there was to be a mutation in the rate of investment, and subsequently in spending, in order to shift the growth trend of the American economy decisively upward. There would have to be other propellants as well—with new and persisting impact. These were found principally in the great potential for stimulation that could be brought about through reforming the structure of the Federal tax system.

Through a sequence of actions, stimulus was given first to investment, then to personal incomes and business profits, and finally to sales of consumer goods. The introduction of modern and advanced equipment was spurred by a special tax credit for investment initiated in 1962, and by a major revision of the standards of depreciation acceptable for tax purposes beginning in that year. Later, beginning in 1964, significant reductions in income tax rates made possible the release to families and firms of a larger proportion of their earnings for spending or saving as they might choose. And then in 1965 a series of reductions began in excise taxes, aimed at lowering prices to the consumer and thereby stimulating buying.

Meanwhile, as prices remained comparatively stable, year by year during the sixties, the annual growth of gross national product in real terms advanced sharply and the volume of savings expanded further, assuring an abundant supply of capital funds to finance rapid increases in investment by private enterprise and local governments. Federal deficits declined as the revenue losses implied by the tax changes were soon offset by the enlarged tax yields from the larger incomes and sales of an advancing economy. The Governmental deficits that remained, though declining year by year, were all financed, in effect, from the same enlarged volume of savings that was amply financing the new high volume of investments.

The formulation of guideposts for wages and prices by the President's Council of Economic Advisers, often identified as "incomes policy", added another important dimension to the new array of public economic policies. By indicating, for all to see, the average increases in productivity from which any real increase in the returns to labor, or management, or capital would have to come, the guideposts provided a substantive meaning to the appeals that various Presidents and other high public officials had often felt called upon to make for "responsible" action in collective bargaining and product pricing. As guidance for all, not as a directive for a few, the United States version of an incomes policy can be a major factor in enabling labor and management to reach settlements that would avoid a recurrence of cost-induced inflation.

On the balance of payments side, progress has been slower. New programs initiated in 1961 were intended to bring results slowly enough to avoid disruption for other countries and yet steadily enough to assure not only that balance would be achieved but also that it could be sustained over the long run. These programs, reinforced in 1963, had achieved many of their intended objectives by 1964 and the deficit should then have been eliminated, had not new outflows kept developing through the capital accounts. For the same abundance of savings which was originally evoked by price stability and rising incomes, and which had been financing the upward thrust of investment and thereby helping in turn to further sustain price stability and expansion within the United States economy, had also overflowed from the United States into other countries. Although the central bank had, beginning in 1960, been doing what it could to edge short-term interest rates upward in order to minimize the comparative attractiveness of rates in other active money markets, over those in the United States, and although that effort was continually reinforced through Treasury debt management, the remarkable flow of savings nonetheless kept the general level of borrowing costs in this country comparatively low and stable throughout these years.

Only the introduction in 1963 of a tax on purchases of foreign securities by American investors, and in 1965 of a voluntary restraint program for bank loans and business investment abroad, have been able to stanch the outflows. The surplus achieved in the United States external accounts during the second quarter of 1965 as capital outflows were sharply reduced—while affording no basis for relaxing effort in any of the many sectors of the country's balance of payments program—does provide telling evidence of the strength which the United States balance of payments position would have been showing for some time if the added capital outflows of recent years had not occurred. The longer run implications of these capital movements for the functions of the central bank, in relation to other arms of economic policy, are among the most troubling issues for the future—to which I will return shortly.

For the first half of the decade of the sixties, however, the central bank, at least as I interpret the record, conceived its part of the new national program as three-fold:

(1) To continue relative credit ease, and enable the commercial banking system to employ its capabilities fully alongside all other sectors of the financial community in support of the needed acceleration of investment in inventory, equipment and construction;

(2) To retain the close contact at the critical margins that would permit a turn toward less ease, or to outright restraint, gradually or abruptly as appropriate, if financial forces began to exert an inflationary impact on aggregate demand and on prices; and

(3) To maintain special watch over the nation's balance of payments position, concentrating its own action, in ways consistent with its other objectives, upon deterring outflows of funds that could enlarge the deficit, and upon developing a network of relations with other central banks designed to protect the dollar and the international monetary system against speculative attacks from any quarter.

Meanwhile, in collaboration with the Treasury and other Executive Departments, the Federal Reserve also began work toward developing those further improvements in the international financial system that can, in time, shift some part of the burdens of reserve asset creation that are now carried so largely by the dollar on to the shoulders of other leading countries.

All of these developments have represented, it seems to me, a wise broadening of the scope of central bank responsibility. But they also involve dangers, as the overlap becomes wider between central banking and other sectors of economic policy.

III. Issues for the Future of Monetary Policy

The necessary preoccupation of economic policy with the stimulation of fresh expansion in the United States economy during the decade of the sixties has extended Governmental activity beyond the customary heavy dependence upon the central bank and brought fiscal policy forward to a prominence never before acknowledged in this country; has brought greater recognition than at some earlier times that the management of the Federal debt can exert a useful, general economic impact, in addition to meeting essential housekeeping requirements; and has given birth to an incomes policy for the United States—an orderly, forceful expression of the public interest implications in the private determination of wages and prices on the national level. In addition, though the central bank itself has also played a large part here, the United States has created a temporary and special program of balance of payments restraint, relying on guidelines of voluntary compliance to moderate outflows of capital and encourage inflows of funds and earnings.

All of these enlargements of economic policy were developed within the Government in consultation with the monetary authorities. The nature and timing of action in any policy sector was, for the most part, harmonized with the prevailing policy of the central bank. And the combined result emerging from the effort on all sides met the acid test of monetary discipline—prices remained reasonably stable, no disruptive speculative excesses or distortion appeared, and the new expansion of the United States economy was kept within the bounds of orderliness and sustainability. Moreover, the economy expanded strongly and unemployment shrank reassuringly.

This substantial enlargement of effective public policy, both within and beyond areas formerly reached by the central bank itself, carries with it serious questions for the future:

(1) In terms of institutional arrangements, will the Federal Reserve, or should it, become more closely identified with the Executive Branch, in order to assure the full coordination of policies?

(2) In terms of policy aims, should domestic growth take priority over international balance? Or growth itself take priority over stability? That is, should emphasis on growth consistently be given the benefit of any doubt over policies designed to minimize fluctuations?

(3) In terms of policy instruments, can there be clear lines of demarcation as to the kinds of purposes for which each of the newly developed approaches should be used? What kinds of interrelations might be expected to evolve among them? More specifically, to what extent can a flexible economic policy be expected to rely upon new legislative action, upon administrative or regulatory action, and upon guidelines for voluntary compliance?

(4) In terms of the United States position in the world economy, what are the prospects for any lasting resolution of two dilemmas that have been of demanding importance during the sixties and for which none of the new approaches has as yet developed comprehensive answers?

(a) The dilemma between maintenance of open and highly developed capital markets for the immense flows of savings within the United States, on the one side, and continuance of a *de facto* inconvertibility for outward capital movements by most other countries, on the other;

(b) The dilemma between maintenance of adequate monetary reserves for the national requirements of the United States and continued access by the rest of the world to these same reserves, and to the dollar, as the principal source of added reserves for the international monetary system.

It seems to me that the recent experience has already provided a glimpse of discernible lines toward a constructive resolution of most of these issues, in ways that could promise even greater results for economic policy in the performance of the American market economy in the future. But there are also more shadowy lines toward serious trouble. I would like to conclude this lecture by noting a few of the dangers as well as some of the more hopeful possibilities.

(1) Institutional arrangements

As to institutional arrangements, the risks inherent in the overlapping of new and old economic policies in the United States call for a firm reaffirmation of the fundamental proposition that the Federal Reserve must remain independent within the Government. Its basic function must always be to serve as the country's conscience, commanding respect for monetary stability—which is indeed only a puritan's euphemism for maintaining the environment of orderliness in which all the markets of a vast economy can be kept functioning most efficiently together in order to produce and distribute the greatest possible output year after year. That requires, as the United States has always provided, a unique status for the central bank outside of the direct chain of Presidential command.

Intimacy and frequency of contact are essential to avoid unnecessary collisions between monetary policy and the rest of economic policy. Mutual interchange widens the awareness of both sides to needs or responses that should be taken into account. But the subordination of the central bank would destroy an integral part of the "checks and balances" structure of our Federal Government. The Federal Reserve, operating within a framework of duly constituted legislation, must be kept as the steady voice of monetary responsibility through changing political administrations. Somewhere within Government there must be assured participation by some entity specially charged to express the underlying and lasting objectives of the nation amidst the inevitable succession of transitory pressures created by heightened excitement in immediate circumstances—pressures which might, unless cautioned and conditioned, lead on to action that would traduce the nation's long-run objecitves. In the wider areas of public responsibility, that is the function of the Constitution and the Courts. It is no far-fetched analogy to suggest that in the narrower area of economic policy, that is the function of the Federal Reserve.

In the unusual circumstances of the past several years, Federal Reserve policy, independently determined, has followed a course which was closely related to the main actions taken by other arms of economic policy. But its accord could never be taken for granted. There had to be, and was, respect on each side for the separate responsibilities of each in working toward the common overall objectives of each. The outcome was a harmonization but not an integration of policies. This is the way these relationships should continue.

(2) Policy aims

As to policy aims, the lines for avoidance of grave conflict are also already visible in the recent experience. The need is to sort out those lines and hold to them. There need be no real conflict between the domestic objectives of the United States and attainment of balance in its foreign accounts—apart from the important and serious problems peculiar to the two dilemmas to which I will return later. The petulance sometimes expressed in the United States over the way in which balance of payments pressures or the international obligations of the dollar seem to be thwarting legitimate domestic economic objectives is, in my view, a kind of emotional escapism from the hard choices inherent in economic life. For the United States cannot realistically practice an economic isolationism. And actually any special pressures related to the dollar's role as a world currency have for the most part simply heightened an awareness of the "balance of payments discipline" that had to be faced in any event. In meeting the tests of international viability, just as in fulfilling the conditions for the effective functioning of the market economy, the United States is in fact best equipping itself for sustained growth at home.

Nor does the recent experience suggest to me any continuous need to put policies aimed at promoting expansion ahead of policies for moderating cyclical upswings or downswings. Early in the sixties, the need for a new thrust toward greater expansion in the United States was so great that the economy could for a time expand rapidly along any lines which the flows of new energy would follow, without seriously risking either the overheating of the whole economy or the overcharging of some sectors. But that phase will also pass. The Federal Reserve has already, as I mentioned earlier, lessened its credit ease somewhat, presumably in order to be in a position of readiness to lean against any excesses that may appear. But it could also more effectively move from this position toward pronounced ease, if a convergence of slackening forces should temporarily occur in the economy.

There will, I feel sure, continue to be need for a changing "mix" of policies aimed in the succession of future events at moderating fluctuations around the economy's rising trend. Evidence of a break away from price stability will probably be one of the most significant early warning signals. But the greatest danger, I suspect, will come from hesitation on the part of political administrations to recognize, at any particular time, the need that a healthy growing organisms occasionally has for a pause—not a setback, but an interval for consolidation and regrouping while relatively little further forward advance takes place. If the natural occurrence of the intervals needed for such sorting-out should be misjudged by the political authorities, and if heavy additional forces should then be trundled out to propel new growth, there might indeed be a return to the unhealthy boom atmosphere of over-exhilaration. But for that, the only answer is that "the watchers must watch themselves."

(3) Policy instruments

As to policy instruments, it seems to me most likely that the central bank, consistently reinforced to the extent possible by debt management, will soon settle back mainly into its accustomed role of aiding the stability of the economy by working against the cumulative force of cyclical patterns, in either direction, upward or downward. Fiscal policy, with expenditure policy at times supplanting tax policy, seems to fit best in the place that has been created for it over these past few years as a primary force for fulfilling the expansionary potential of the market economy.

Such an approximate and flexible distribution of functions would agree well, too, with the continued reliance of monetary policy and debt management upon administrative decisions, variable within relatively short periods of time, and operating within a framework of general legislation. Fiscal policy, by contrast, must no doubt largely remain dependent upon specific Congressional enactments affecting taxes and expenditures, as recommended by the Executive in the light, among other considerations, of the current momentum of the economy. Usually slower to start, and more cumbersome to reverse, fiscal policy can best be directed to provide underlying propulsion for the economy.

The scope for incomes policy, or for such other temporary reliance on guidelines as the current voluntary restraint program for the balance of payments, will depend, it seems to me, upon the capability of the other arms of economic policy for maintaining necessary supporting conditions, both in terms of the economy's cyclical fluctuations and its long-term trend. Any attempt to elaborate either type of voluntary approach through detailed legislation, to be carried out by detailed administrative determination, would in the United States pose a serious threat to the scope for initiative and individual variation that is inherently required for the vitality of a market economy. Yet in the intensely competitive American economy, with price leadership an inherent concomitant of the large size that has become necessary for many establishments in order to achieve maximum efficiency in many of the major industries—from the side of both management and labor —there must be ways to provide some alternative to a continuous sequence of upward ratcheting in the wages or prices of near rivals.

It seems to me that so long as monetary and fiscal policies are being directed to maintain an appropriate environment of expansion without inflation, thereby narrowing the open area over which certain key business decisions can be expected to range, the final patterns of such decisions can become reasonably responsive to a voluntary effort. The success of economic policy over recent years in maintaining price stability, for example, has created an environment in which guideposts for overall wages increases have at times been crucially useful in avoiding settlements that could otherwise have caused an outbreak of cost inflation. At any rate, in my own view, effort along these lines offers much more promise, and less ultimate risk to the sustained functioning of a market economy, than the mere enjoining of management and labor to be "responsible"—which has so often led only to debilitating industrial strife, partly for lack of a clear indication as to the meaning of "responsible" from the public interest point of view. In these terms, the "guidelines" sectors of economic policy may become a vital part of the useful influences which Government can exert from time to time upon the framework within which a market economy can flourish.

(4) The stubborn dilemmas

(a) Capital flows and the role of interest rates. The single most disturbing cause of the imbalance in United States accounts over these recent years, and the one for which none of the traditional precepts of international adjustment suggests an effective early answer, is the tendency for capital to flow out of an economy which has relatively stable prices and high savings toward those economies which block or impede

the outflow of their own capital, which have in any event a greater need for capital in relation to their own savings, which are also often undergoing some internal inflation and which thus offer significantly higher rates of interest.

The answer of traditional thought, articulated over and over again with a kind of moral assurance by critics who did not seem to be aware of the fundamental nature of the new stage that was reached in the evolution of the American economy in the early sixties, has been simply to raise interest rates in the United States. That this advice springs from such a lack of understanding is revealed by the frequently heard comment that, after all, Europe has been enjoying remarkable expansion while paying high interest rates, consequently similar high interest rates should not deter expansion in the United States. The difference, of course, comes in the causation. Any economy must, if its expansion drive is in a self-propelling phase, and its savings are relatively small or imperfectly allocated, experience higher rates of interest. And in such an economy, subject to the chronic inflationary tendencies of high growth rates, it is quite normal for the central bank to apply restraint —a restraint which seems to some to be a primary cause, and is certainly at least a contributing cause, of the higher level of interest rates.

But there is no comparability between those circumstances and the position of the United States in the early sixties. Here, the need has been to stimulate expansion. Here, there was no excss of investment demanding pulling interest rates upward, while assuring a continuance of vigorous growth. Here, any marked rise in interest rates during recent years would only have been attainable by a drastic cutback in the supply of savings, for the United States after 1961 was already doing everything it reasonably could to stimulate the demand for capital by promoting internal investment. And that stimulation, marked as its results have now been, has still produced no rise of interest rates whatsoever because it has been paralleled by the burgeoning savings of an economy enjoying price stability.

The scale of central bank retrenchment that would have been necessary to accomplish a major upward shift of interest rates in this country, once the supply of savings had reached magnitudes in the early sixties that actually exceeded the total amount of the gross national product of most other countries, would have been calamitous in my judgment, not only for the United States but for the world economy. That is because interest rates, just as other prices, cannot be sustained at levels that are very far distant from those dictated by the underlying supply and demand situation. And as Per Jacobsson wrote in 1917, ". . . it would hardly be possible to devise a measure less calculated to increase industrial prosperity than the maintenance of the rate of interest for borrowed funds at a level higher than the real rate." [3]

What then is the prospect? The brightest, but still most elusive, would be a dismantling of trade barriers that permitted the United States to increase its exports sufficiently to offset any deficit in its accounts created by the outflow of financial capital. Or in time, perhaps as the expansion of the United States economy continues, capital demand may reach such an intensity here as to bring about some relative increase in the level of United States interest rates. But if the pace of increase in savings continues to be encouraged by a continuance of price stability, that pattern offers comparatively little hope for an adequate resolution of the dilemma. Nor can foreign borrowing demand become so large as to cause a general rise in interest rates here that could bring an equilibrium on an international scale. For even though foreign demand can be expected to continue pressing on the American economy, ways will have to be found to keep the dimensions of that demand which the United States can permit to be fulfilled within the limits permitted by the overall United States balance of payments position.

There may, in quite another direction, be some room for hope that the fragmented and underdeveloped capital markets of Europe will, as has so much of European industry, follow the path toward "Americanization". Once efficiently organized, the European markets could increase the availability of the savings now arising there for meeting a broader range of the European investment demands, correspondingly reducing that part of the demand that is now reaching for the savings of the United States. And if those conditions were fulfilled, perhaps more of the European countries could consider a true opening up of the blocked capital markets that now prevail in most of Europe, and possibly some amalgamation among them. That, in any shorter-term sense, seems the most promising route toward reduction of foreign dependence upon the United States capital markets.

Another possibility is that the rate of economic advance in Europe and elsewhere may begin to slow down, as indeed in some countries

[3] *Some Monetary Problems—International and National op. cit.,* p. 8.

it already seems to be doing, and that prospects may improve there for price stability. This in turn might mean some relative lessening of the European demands for capital along with a relative rise in the European flow of internal savings. Perhaps there might then be grounds for some easing of central bank policy in the other more developed countries, and in time some of them may even find themselves in the position of the United States in the early sixties.

But these, of course, are all conjectures. They show the outline of possible equilibrating tendencies but offer no assured promise of early solutions. There will for some time, I fear, have to be unwanted and intrinsically undesirable limitations on the free flow of United States capital abroad—until some of these possible equilibrating trends begin to take shape. Meanwhile, there is one conclusion of which I personally feel certain. The central bank in the United States, though it will surely continue to do all it can to promote and maintain balance of payments equilibrium, could not solve this fundamental dilemma by any action that lies within its means. That does not represent a lack of will, but the impossibility of treating the problems of the new phase in the economic development of the United States with the methods appropriate for quite different circumstances—those of the central bank that is faced by a sustained balance of payments deficit when its economy is self-propelled and fully employed.

(b) The dilemma of the dollar as a reserve and national currency. The emphasis which the United States could give to any suggestion for innovation in the international monetary system during the early sixties had to center clearly and explicitly, at least until equilibrium was assured for the United States' own accounts, on erecting new defenses for the dollar to be used in resisting speculative pressures created by international developments, and on strengthening the existing resources and capacity of the International Monetary Fund. Meanwhile, so long as the dollar remained the major reserve currency, and there was no practicable early possibility of bringing the currencies of other countries into a direct sharing of the reserve currency functions provided by the United Kingdom and the United States, this country resisted piecemeal approaches to major reform. However well intended, these could only, in the circumstances, create uneasiness or unrest, and in that way interfere with the functioning of the existing international monetary system.

Instead, the United States joined actively in the practical enlargement of existing arrangements among the central banks of various leading countries—with striking results in resisting the waves of speculative disturbance that soon followed the widespread restoration of current account convertibility at the end of 1958. It encouraged and participated in a remarkable broadening of international financial cooperation among the financial officials of governments, as well as the central banks, most notably within the Organization for Economic Cooperation and Development. And it helped to initiate a series of probing studies, under the aegis of both the International Monetary Fund and the Ministers of the Group of Ten, into the nature of the existing international monetary system and its possible future needs.

The outcome of all these efforts, now that the United States balance of payments is showing some reassuring signs of strength, is that negotiations can begin to succeed the studies. Increased attention can be given by governments to the dilemma posed by the heavy dependence of the rest of the world upon the same dollar and the same reserve that must also meet the national needs of the United States economy. Hopefully, new progress will emerge following the meeting of the International Monetary Fund that has just been concluded. I have just published in book form my own views on the implications of this aspect of monetary policy in the United States, so I will not try to reproduce them here in a lecture that has already become overlong.

I do want to stress the conclusion, however, that the United States dollar will undoubtedly continue to be used, and probably increasingly used, as a vehicle currency for handling the payments requirements of the bankers and traders of the world. I also believe that it will continue to serve, at least on the present scale, as a useful and reliable reserve currency as well. And I am certain that in all events the United States will keep the $35 gold price immutable.

The world is growing too fast to remain dependent primarily upon the expansion of one currency for its reserves. It has for more than twenty years, since Bretton Woods, been implementing multinational facilities for lending reserves to countries for meeting a part of the needs created by the swings that dynamic change inevitably brings in their individual balance of payments positions. The time is approaching to channel similar multinational effort into the further creation of the reserves that can be earned and owned.

The great need will be to find ways in which the other more developed countries can continue the trend that began under Per Jacobsson's leadership in 1961 when ten of the leading countries joined in the

General Arrangements to Borrow as a means of reinforcing the reserves of the International Monetary Fund. An important next step will be to find some way of enlarging the participation of countries such as these in further support of the international monetary mechanism through mutual contributions toward the creation of a generally acceptable reserve asset. In time, I feel sure that additional means will be agreed upon for some creation of additional monetary reserves, just as there will be continued expansion of credit facilities, not only bilaterally but more importantly through the International Monetary Fund. It will be essential to enlarge both kinds of liquidity to serve the requirements of a growing world economy.

* * *

This survey has been able to include only selected aspects of the evolving relations between monetary policy and other elements of economic policy, in only one country. Incomplete though it has been, I think the experience that it represents does point toward five important conclusions:

(1) The United States has entered a new phase in the development of modern economic society, requiring an enlargement of the scope of economic policy—for both domestic and international objectives.

(2) Domestically, this means that fiscal policy and incomes policy will henceforth function alongside monetary policy—fiscal policy, primarily to generate stronger growth; incomes policy, primarily to avert cost-inflation; and monetary policy, primarily to moderate cyclical swings.

(3) Externally, because of structural disequilibria in the investment-savings relations among the industrialized countries, capital flows are likely for some time to be a cause of imbalance for the United States, and the usual role of monetary policy in effecting adjustment will have to be supplemented in other ways, including the observance of voluntary guidelines.

(4) Internationally, the monetary role of the United States dollar in providing world liquidity will be increasingly augmented by the further development of credit facilities and the additional creation of reserve assets, notably through the International Monetary Fund.

(5) The fundamental role of monetary discipline will continue as a primary condition for the exercise of all arms of economic policy.

In all of this, the world will be following the Per Jacobsson tradition —assuring monetary adequacy in a context of monetary discipline, evolving new methods for the assurance of that monetary stability which is essential to the peace and prosperity of all nations in an era of unequalled economic expansion.

QUESTIONS AND ANSWERS

Written questions were submitted to the speakers by members of the audience. Each of the two principal speakers dealt with the questions addressed to him specifically, as follows:

DR. DESHMUKH: I have two questions here. One is: Can India afford slower progress, even to avoid a costly error of judgment?

I said that slower progress is the price that you pay for the various handicaps that a developing country suffers from. And if you attempt to attain greater progress with the means at your command, you are not able to achieve it. That is to say, if you are rash, for instance, if you create credit more than is necessary, then you lead to consequences which finally involve very high social costs, and in a society like India, social costs will certainly be going against the main objectives of the social and economic policy espoused by government; namely, that the rich will be richer and the poor will be poorer.

Therefore, it seems to me that progress, even if it is pedestrian, is preferable to inevitable distortions of the economy which will lead to more serious consequences.

The answer, I think, doesn't lie in the field of economics so much, so far as slower progress is concerned, as perhaps in the field of population control. In other words, when the gross national product is divided up among a population growing at a very high rate, then what you see is slower progress; that is to say, low per capita incomes, low rates of growth, and so on.

But if successful measures were to be taken with regard to population control, then, it seems to me, that whilst avoiding costly errors, you would be able also to accelerate progress so far as the raising of per capita levels of living are concerned.

The other question is: Would not an important active and vigorous general monetary policy make it easier to operate selective controls without hampering growth and development?

I already said in my statement that a general monetary policy operates in a different way in regard to selective controls than is done in the Indian situation. Here that has to be a more eclectic principle and a more direct application of selective controls, which are not dependent on the regulation that is brought about by a general monetary policy.

Nevertheless, in recent years, as contrasted with previous periods, in India, there have been attempts to match selective controls with the manipulation of monetary policy, particularly the interest rates. I think therefore, to a certain extent, the principle which is involved in this question was already considered within the limits, of course, of the sort of developing economy that India is. In other words, one might say that the economy gets more sophisticated, there is a greater recognition of the use and possibile advantage of an alert—I don't know about vigorous, but an alert general monetary policy, in conjunction with selective controls.

* * * * *

MR. ROOSA: I have four questions that are basically the same; I will read them quickly, because they all point certainly to the same answer.

One is: When do you consider that central bank policies do influence the flow of liquid funds in an artificial way, and when don't they?

Another: To what extent do I think that the supply of savings in the United States is at all price elastic?

Another is: Is it correct to believe that the high rate of savings was unrelated to monetary policy in the United States?

And the fourth: Does the recent high flow of savings in the United States represent, to some degree, credit creation by the central banking system?

The best way to pull all those together in a single reply is to say that, of course, the central banking system was adding to the supply of money and the availability of credit over this period. It was, however, doing so through much of the period with somewhat less readiness, somewhat decreasing readiness of availability from 1961 onward. Nonetheless, through each of the years in terms of the grand aggregates of additional funds, attributable to various sources, the banking system as a whole did provide additions to the flow of funds. Data of the Federal Reserve Board show increases that ran 17, 18, 19 or 20 billion each year.

This was the contribution of the banking system as a whole, superimposed on many other forms of additional liquid savings in the economy, so that I, by no means, deny that there was an increase. The increase, of course, was much of the time resulting in a growth in the money supply that was rather well related, of course, most of the time to the growth in gross national product. So, of course, the test is that this is entirely appropriate so long as there is not only a widespread underutilization of resources and extensive unemployment, but also so long as that part contributed by the banking system is superimposed on the remaining flow of savings in such a manner and volume that its marginal significance does not produce an increase in the general level of prices.

I think that test was met throughout this period. And as soon as price inflation does become the danger, then, of course, we have reached the stage where conscious and explicit central bank restriction has its clear role.

I tried to say more about that in the paper, but I certainly didn't do it very well in my quick trip through just now.

A couple of other questions quickly: A possible way of bringing up the lack of domestic investment to meet the volume of national savings would have been to expand investment expenditure in the public sector. What do I think about that?

In the paper, again, I have a few words on this. You may not believe it, but I really did cut the paper, even as it appears in print. I once had in it a couple of pages trying to answer that. The principal reservations that I have here are that in a fundamentally private economy, oriented to the generation year after year of sustaining investment from the decisions and the will of the private sector, it was most important that we make our major effort on this front. Of course, there has been through most of this period a rather tight control on public investment, at the Federal level. I do believe that in time, as the gross national product goes on further increasing, and the by-product in terms of higher tax revenues is also substantial, that we may well find that there will be scope for a paralleling of that with some increase in, some further increases in, domestic investment by Government. And as you know, within the framework of many of the Administration's present programs, there is scope for substantial increase if and when the over-all budgetary picture permits it. But it has been an important part of this process, which I short-cut in this description, that we have been very careful to see to it, that throughout the period, because we were emphasizing—I say "we" because it used to be something I could be identified with—certainly emphasizing the stimulation of investment in the private sector as the lasting, sturdy base. Therefore, even though there are those who would note that there was a formal deficit in the federal government's accounts, this was not, in fact, a deficit which had to be financed out of any part of this savings flow.

For the last two years, as most of you know, although there is an indicated deficit, all of that deficit has been met out of normal increases—which, as we have already seen, have been normal in pace with the growth of the gross national product—normal increases in the holdings of government securities by the Federal Reserve System, and holdings of government securities by the various social security and other trust funds.

There has been a reduction in the demand for the savings of the economy as a whole, coming from the federal government. The indicated federal government deficit has not been an actual deficit. It is accounting, not economics.

The final question: Would I comment on the financial intermediary role of the United States in international finance and on the contribution of that role to the balance of payments deficit? It is true that, by serving as the major capital market for the world, we, at a time when we had too little investment to use all our savings facilities, had this spilling over of an enormous flow of additional liquid savings. Our role here as a financial intermediary was the vehicle through which undue pressure eventually developed on our balance of payments. That diminished the gold reserve on which all the world presently depends for the sustainability and the liquidity of the dollars and other reserve assets they like to use. So we did have to turn to some kinds of limitations.

We turned to them grudgingly and slowly, always preserving the maximum range still for the fulfillment of the private sector's role within all of these markets. Whether what we have done is right or wrong, I do argue in the paper that limitations of this kind—in effect, interference with the full flow of capital through the United States market to the rest of the world—have been made essential by what I described as, for the time being at least, a fundamental structural disequilibrium between the economic nature of the American economy and that of the other developed countries.

* * * * *

MR. BURGESS: Again, on your behalf, I extend our very great thanks to Dr. Deshmukh for coming here all the way from India at a critical time and giving us so much of his time and experience; and to Mr. Roosa for his very careful analysis.

Their full speeches will be published. I am sure that we will want to study them with very great care.

I also again thank all of you, the shareholders of The Per Jacobsson Foundation, for your support and your interest. We have started something here that will go forward over the years.

We will have announcements to make from time to time as to what we plan to do further. We would be glad to get suggestions from any of you.

CONCLUDING REMARKS

MR. MARTIN: It was my privilege earlier to welcome The Per Jacobsson Foundation to Washington. It would have been presumptuous for me also to have welcomed at that time one of my mentors, the President of the Foundation, Dr. Burgess. I think all of the people in this room know the contributions that he has made in this field, and there are probably very few of us who haven't read his book, THE RESERVE BANKS AND THE MONEY MARKET. I just want, in concluding the meeting, to congratulate all of us on the fact that he has assumed the presidency of this foundation. It augurs well for all of us that a man who has made the contributions that he has is helping carry forward the work of Per Jacobsson.

I also want to say that I am very much indebted to Mr. Roosa for the assistance that he has given the System, and to my friend, Dr. Deshmukh, whom I have known through the years. This has been a very happy occasion for me. Thank you very much.

MR. BURGESS: On that happy note, we will adjourn the meeting.

Appendices

BIOGRAPHY OF C. D. DESHMUKH

C. D. DESHMUKH has, for the greater part of his life, been involved in various aspects of public service to his country. For twenty-one years, as a member of the Indian civil service, he dealt with a wide range of responsibilities for the Central Provinces and Berar, and for the Government of India.

In 1939 he was appointed as Secretary of the Reserve Bank of India and, two years later, as Deputy Governor. In 1943 he succeeded the late Sir James Taylor to become the first Indian Governor of the Bank, a post in which he served for six years. During this period he organized and established the Bank's monetary and economic research work on a firm footing. He represented his country at the Bretton Woods Conference in 1944 and served as India's Governor of the Fund and Bank from 1946 to 1956.

In 1950 Dr. Deshmukh became Finance Minister of Union Government and, in September of that same year, was elected as Chairman of the Joint Annual Meeting of the Boards of Governors of the two Bretton Woods institutions in Paris. He entered the first general elections held in India in 1952 and was successful, remaining a member of the Indian Parliament until 1956. It fell to him as Finance Minister to nationalize the former Imperial Bank of India and the life insurance companies in India. In 1956 he resigned his post as Finance Minister.

A fourth career, in the field of education, began for Dr. Deshmukh with his appointment in 1956 as Chairman of the University Grants Commission and, in 1962, as Vice Chancellor of the University of Delhi, a post he still holds. He is also currently Vice Chairman of the Indian Institute of Advanced Studies, a member of the Governing Body of the Indian School of International Studies and a member of the Board of Trustees of the United Nations Institute for Training and Research.

Dr. Deshmukh, who was born on January 14, 1896, was educated at Elphinstone College, Bombay, and at Jesus College, Cambridge, of which he is an Honorary Fellow. He is also a member of the Inner Temple in London. He now makes his home in New Delhi.

BIOGRAPHY OF ROBERT V. ROOSA

ROBERT ROOSA began his career in the field of economics as an instructor at the Universities of Michigan and Harvard and later at the Massachusetts Institute of Technology in Cambridge. While at M.I.T. in 1940, he also worked part of each week in New York as an economist-statistician with the Federal Reserve Bank of New York. On returning from army service at the end of World War II, he continued full-time at the Federal Reserve Bank of New York, alternating between responsibilities on the domestic side and in international financial affairs. From 1953-1956, as Assistant Vice President, he managed the Bank's securities trading operations for the Federal Reserve and the Treasury. From 1957-1960, he was Vice President in charge of the Research Department.

In January 1961, Mr. Roosa became Under Secretary for Monetary Affairs in the United States Treasury, where he served until the end of 1964. During that period his principal responsibilities related to the management of the public debt, coordination among the various credit programs of the Federal Government, relations with the Federal Reserve and other banking and monetary agencies, and the Treasury's international activities, particularly those relating to the balance of payments and to gold and foreign exchange operations. He was especially involved in developing new approaches to international financial cooperation, and he participated actively as representative of his government in the regular meetings for coordination of balance of payments policies among members of the Organization for Economic Cooperation and Development. He also helped in the origination of arrangements through which the "Group of Ten" industrial countries undertook new relationships with the International Monetary Fund, designed to augment the Fund's resources in cases of special need. He chaired a group of Deputy Ministers from these countries during the first phase of an intensive re-examination of the international monetary system in 1963 and 1964.

At the beginning of 1965 he joined the private banking firm of Brown Brothers Harriman & Co. in New York as a general partner.

Mr. Roosa was born on June 21, 1918, and was educated at the University of Michigan. He now lives in Harrison, New York.

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