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**THE THEORY OF
MONETARY POLICY**

THE THEORY OF MONETARY POLICY

WITH SPECIAL REFERENCE TO THE
RELATION BETWEEN INTEREST RATES
AND PRICES

BY

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TO THE SACRED MEMORY
OF
MY FATHER

PREFACE

IN modern monetary philosophy no subject has perhaps provided more food for thought or more cause for disagreement than the use of the bank-rate mechanism towards the control of prices and of the courses of production and employment. There are, as even the most casual reader must find for himself, not only the keenest differences as to the ultimate ends of monetary policy, but the most fundamental divergences of views as regards the technique of monetary control, the precise manner of operation of the various instruments at the disposal of banking systems and as regards the interpretation of facts and figures relating to the mutual interactions of monetary events and industrial developments. It would be audacious on the part of anyone, who had not the necessary practical experience born of a constant and long-standing intellectual contact with current economic developments, to pretend to make a first-rate and original contribution to thought in this highly controversial field. This small book, however, is not intended to be a comprehensive treatise on all aspects of monetary policy ; nor is it written with any ambition of throwing a searchlight on the vast statistical and theoretical material made available by contemporary events on the one hand and by their commentators on the other. My object here is only to bring together some modest *obiter dicta* on banking policy, on the relation between interest rates and prices and on the ultimate ends of monetary control and to give them a coherent shape. Not all of us economists can profess to have that mastery over mind and matter that is essential to the production of full-fledged text-books. At the same time, I believe, a useful purpose will be served

by the presentation of such theoretical schemata by those who are engaged in the study of kindred subjects; so that by exchange of ideas and mutual criticism a system of doctrines may be built up in which the differences shall be less emphasised than the agreements.

On a perusal of the book it may appear that I have devoted considerable space to current controversies on the subject of bank-rate policy. This is partly due to the fact that I began working on these problems at a time when, on the publication of Keynes's *Treatise on Money*, these controversies were at their keenest and the issues seemed to get more and more clear-cut like refined diamonds as the discussions advanced. But more particularly, it is due to my belief that in any discussion of an "ideal" rate of interest, it is impossible not to make reference to the various notions then put forward.

Ricardo¹ was probably the first to speak of a "natural" rate of interest in the modern sense, although he did not develop the notion sufficiently. Since then we have been made acquainted by monetary writers with a variety of other analogous concepts. It will not be difficult for the reader, however, to discern the intellectual genealogy of this effort and he will at once perceive how deeply indebted I am to J. M. Keynes, that leader of modern monetary thought, in much that I have to say in the following pages. In places, of course, I have taken the liberty of differing from him, particularly in the application of the "natural" rate theory to practical banking and as regards the ultimate ends of monetary policy, but the differences are of small consequence. For my attempt is mainly to explore parallel vistas of thought rather than to contradict, and I firmly believe that Keynes has given us a new vision and a new methodology of approach

¹ Cf. *Essays* (Gonner edition), p. 35, where he speaks of a "natural level of interest."

towards the difficult problems of monetary science, which seem to get more, not less, complex with the passage of time. That is only Cæsar's due, however, and it will be realised by the reader that in the following pages my allegiance, where such was necessary, has been eclectic and impartial.

I must here express my gratitude to Mr. D. H. Robertson for kindly replying to some of my queries and to Dr. Brinley Thomas of the London School of Economics for going through the portions dealing with the Wicksellian theory and offering helpful criticism. I need scarcely add, however, that the responsibility for views expressed in the following pages is entirely mine.

I am also particularly thankful to the Editor of the *Economic Journal* for permission to incorporate in this book a Note by me on "Fisher's Real Rate Doctrine," which appeared in the *Journal* (June 1934), and to Messrs. Riefler & Simmons and the American Economic Association for allowing me to reproduce from the *American Economic Review* (June 1933) a Chart showing relative movements of long- and short-term rates.

B. P. ADARKAR.

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PRELIMINARY

It can hardly be gainsaid that, in an insane and chaotic world, a deliberate, concerted monetary policy is one of the few sane methods left to the rulers of society to anticipate, check and alleviate the industrial maladies to which the world is periodically liable. Used with precision and sense, it is undoubtedly a great stabilising force ; while, contrarily, if mishandled, it can as certainly be a disruptive one. The great problem of banking is a twofold one : in the first place, some measure of agreement has to be arrived at as to what should be the goal of monetary policy ; secondly, the question must be decided as to what exactly has to be done to reach that goal. The relation between prices and production, the questions of appropriate outputs, of appropriate fluctuations of output and such-like issues are of far wider significance than can easily be dismissed within the compass of a few pages or with superficial reasoning. However, it appears to me that in this modern, fast progressing world, in which there is not only an actual plenty but still greater opportunities of plenty, we must devise a monetary technique which will make available to us the means of realising all those potentialities of production and wealth. It is my belief that in this realisation the economics of "dynamic equilibrium" is capable of playing a most distinguished part. It is rather unfortunate that precisely where monetary theory may be expected to come to the aid of practical banking and help it formulate some rational policy of control over the movement of prices and production, the theory is shrouded in confusion and controversy. Far be it from me to suggest that there are not operating upon the monetary and industrial structures, real and physical forces, whose scope and magnitude it is not always possible to foresee, but that does not mean that monetary authorities have not a function to perform in the scheme of industrial affairs. It is impossible to entertain the

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suggestion that the monetary machine should be left to find its own manner of operation and take its own natural course: such *laissez-faire* is unthinkable for a mechanism which is capable of both so much good and evil.

It would be idle to pretend that on such highly controversial issues it is possible for anyone to say the last word. My endeavour in the following pages is to clear up certain theoretical questions connected, firstly, with the relation between interest rates and prices, which undoubtedly forms the central theme of practical banking policy, and, secondly, with the ultimate objective of monetary policy and the methodology of monetary control. Incidentally, I have been compelled to delve into some adjacent problems, such as the theory of barter, the nature of capital and so forth, but in each case I have confined myself only to the relevant parts of such theories without indulging in a rambling rigmarole of polemical economics.

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