

SHADOWS OF HYPER-INFLATION

BY

S. K. MURANJAN

M.A. (BOM.), B.Sc., D.Sc. (LOND.)

PRINCIPAL AND PROFESSOR OF BANKING.

SYDENHAM COLLEGE

AND

INSPECTOR OF COMMERCIAL SCHOOLS,

BOMBAY PROVINCE



HIND KITABS LIMITED
PUBLISHERS : : BOMBAY

TO
MY WIFE

Who has more cause to resent inflation being
concerned with things outside the study-room

BY THE SAME AUTHOR

Economics of Post-War India (Hind Kitabs)

Economics of the Cabinet Delegation's Proposals
(Hind Kitabs)

The Budget and After (Hind Kitabs)

Modern Banking in India (Third Edition in Press,
Hind Kitabs)

Foreign Banking Systems (in Marathi ; in Press,
Hind Kitabs)

AND PROF. C. N. VAKIL

Currency and Prices in India (Longmans)

PREFACE

The present booklet is a restatement of a theme first advanced in an article contributed to the Independence Number of the *Forum* of Bombay and elaborated subsequently in four lectures delivered to the Banking Association of the Podar College of Commerce, the Marathi Literary Association of the Sydenham College, the Bombay Discussion Group and the Social Contact Group.

A few months before the end of the War, I wrote in *Economics of Post-War India*, ".....the danger of a further inflation superimposing itself on the inflation of war years arises from more than one quarter—the unleashing of the pent-up forces of investment, the release of hoarded currency and bank balances, the super-normal level of cash reserves and subnormal level of loans and advances of banks.....In an all-round sanguine environment like this a cheap money policy by the Reserve Bank can only aggravate the upward trend and make the ultimate crisis and collapse more certain."

In discussing the "International Background of Post-War Planning", I observed in the same book: "It is more consistent with the logic of facts that the co-operation of the future will be one of pacts, compacts and agreements and that behind this facade will operate not rational economics, but political power, pure and simple. If this analysis is correct, closed economy rather than inter-country mobility of capital and labour will be more compatible with the spirit of the future."

Immediately after the end of the War, I observed in the second edition of the aforesaid work: "It appears therefore reasonable to conclude that the volume of expenditure during war whether financed out of taxation and borrowing or by inflation need not leave behind it a legacy of adverse effects on the volume of output or employment."

Unfortunately, those who were in power and those who offered themselves to be their advisers were all haunted by fears of uncontrollable deflation and they blundered into measures which kindled the fires of an uncontrollable inflation. Whatever chance there appeared for a short time of reaching stable conditions were more than destroyed by precipitate decontrol

unaccompanied by any precautions to hold in check monetary factors.

The outcome has been described by some as an 'economic crisis'. We are certainly not in the midst of an economic crisis in the scientific sense of the term. We are at present treading the road to economic attrition and atrophy. The crisis, if it ever comes, will not be an economic crisis: it will be a crisis of social relations—between man and man, class and class, the power of Capital and the power of Labour. The voice of Economic Wisdom, if there ever was any in this country, will be as ineffective then as it has been in the past. In no country is Truth invoked more *ad nauseum*: in no country is Truth, when unpalatable, more resented or covered with genuine or calculated quackery.

I must acknowledge thanks to the Editor of the *Forum*, through whose kind courtesy the article referred to earlier has been reproduced as an Appendix in this book.

Sydenham College of
Commerce and Economics }
Bombay, 31st December 1948 }

S. K. Muranjan

THE FINGER OF HISTORY

HYPERINFLATION IN AUSTRIA

An economist who knew how to describe graphically all the phases of the inflation which spread from Austria to Germany would find it unsurpassed material for an exciting novel, for the chaos took on ever more fantastic forms. Soon nobody knew what an article was worth. Prices jumped arbitrarily; a thrifty merchant would raise the price of a box of matches to twenty times the amount charged by his upright competitor who was innocently holding to yesterday's quotation; the reward for his honesty was the sale of his stock within an hour, because the news got around quickly and everybody rushed to buy whatever was for sale whether it was something they needed or not. Even a goldfish or an old telescope was 'goods' and what people wanted was goods instead of paper. The most grotesque discrepancy developed with respect to rents, the government having forbidden any rise; thus tenants, the great majority, were protected, but property owners were the losers. Before long, a medium-sized apartment cost its tenant less for the whole year than a single dinner; during five or ten years ... the population of Austria enjoyed more or less free lodgings ... A man who had been saving for forty years and who furthermore had patriotically invested his all in war bonds became a beggar. A man who had debts became free of them. A man who respected the food rationing system starved, only one who disregarded it brazenly could eat his fill. A man schooled in bribery got ahead, if he speculated he profited. If a man sold at cost price he was robbed, if he made careful calculation he yet cheated. ... Because Austrian money melted like snow in one's hand every one wanted Swiss francs or American dollars and foreigners in substantial numbers availed themselves of the chance to fatten on the quivering corpse of the Austrian krone Every hotel in Vienna was filled with these vultures; they bought everything from tooth-brushes to landed estates, they

that this overexcitation was unbearable for the people, this being stretched daily on the rack of inflation.....And secretly it hated the Republic, not because it suppressed this wild freedom, but on the contrary, because it held the reins so loosely Around Ludendorf, more than the then still powerless Hitler, the counter-revolution was already crystallizing openly: the officers whose *epaulettes* had been torn off their shoulders organized in secret, the small tradesmen who had been cheated out of their savings silently closed ranks and aligned themselves in readiness for any slogan that promised order... Nothing ever embittered the German people so much,—it is important to remember this—nothing made them so furious with hate and so ripe for Hitler as the inflation...The inflation served to make it feel soiled, cheated, and humiliated; a whole generation never forgot or forgave the German Republic for those years and preferred to reinstate its butchers.....

—*The World Yesterday*
(Stefan Zweig)

Monetary Trends of War

Leaving out of account foreign loans or any investments held abroad, a country can find the means for war by withdrawing men and resources from the employments of peace, by more intensified exploitation of resources hitherto used or unused and finally by postponing replacement of equipment built up during years of peace. The ordinary financial or monetary equivalents of these sources of the sinews of war are the consumption-expenditure, ordinary savings and depreciation reserves of the community in the aggregate. The most straightforward means to finance a war is therefore to levy the maximum taxation on individual and corporate incomes and/or to compel or prevail on all classes of people to subscribe the excess over the minimum of consumption to public loans. It is not found feasible, however, in every country to employ taxation in such a manner as to reach every income-receiver or to equalize incomes and yet retain the economic incentive required to reinforce the urge of patriotism. Unequal incomes create two difficulties. Firstly, they mean unequal consumption out of a strictly limited stock of things to prevent which rationing and price-controls have to be invoked. Secondly, combined with rationing and price-control, unequal incomes mean unequal savings which might run into idle hoards or undesirable forms of investment unless they are intercepted at the source or forms of investment are strictly controlled.

Taxation and loans were the principal means by which the United Kingdom and the United States met the bill of World War II. Profiting from the experience of World War I, both countries had formulated their financial policies with the utmost care and completeness and lost no time in putting them into effect. In India, forethought had no place in the policies of the British Government and haphazard measures, improvisation, conflict of policies, etc. fell to the lot of the bewildered and unorganized people.

RUPEE FINANCE DURING THE WAR (Figures in Crores)

Year	Visible Balance of Trade in Merchandise of British In- dia (excl. of re-exports, private) *	Sterling pay- ment by H. M. Govt. (against War Expendi- tures Recover- able from Br. Govt. shown in brackets)	Defence Capital Expenditure	Revenue Surplus (+) or Deficit (-)	Total Rupee Finance to be met (Columns 1+2+3+4)	Rupee Finance met from loans †	Rupee Finance met by issue of currency, i.e. Absorption of Notes & Rupee coin **
	1	2	3	4	5	6	7
1940-1	+29.93	43 (53)	...	- 6.5	79.4	+124	56
1941-2	+64.31	199 (194)	...	- 12.6	275.9	+ 37	164
1942-3	+77.18	310 (325)	52	-112.1	551.2	+137	318
1943-4	+80.35	365 (377)	37	-189.7	672.0	+252	282
1944-5	+53.08	457 (410)	62	-161.0	733.0	+206	231
Total	304.80	1374	151	-481.9	2311.0	756	1001
1945-6	+24.11	342(Re)(347)	14	-123.0	524.0	+277	162.2
1946-7	+28.65	...	...	- 55.7(Re)	...	...	31.1
				- 6.0(Re)	...	...	53.9

*Sterling amounts utilized for Repatriation	Total Govt. outlay on account of Defence & exp., Defence capital exp., Exp. recover- able from Br. Govt.	†Treasury Bills (Average amounts outstanding with public)	** Increase in sterling holdings of Reserve Bank (i.e. total sterling purchased & sterling payments by H.M. Govt. minus Repatriation of Debt and other Sterling commitments)	Defence Loans	
1940-1	89	...	26	2	85
1941-2	110	297.9	...	140	64
1942-3	160	592.6	...	227	100
1943-4	16	973.7	122	434	341
1944-5	14	896.2(Re)	...	418	266
Total	389	...	...	1221	856
1945-6	...	900.7(Bud)	...	361	376

Financial and Economic Policies

The financial and economic policies of war years must be judged against the avowals or confessions of the Finance Member from time to time about economic conditions in the country. When he presented his three budgets for the years 1940-41 to 1942-43, he found no cause for any serious concern. The budget of 1940-41 found the prices of chief articles of export 40 per cent higher than at the outbreak of the war and there was no marked difference in the trend of prices of raw materials, industrial commodities, food, etc. "The different branches of the national economy", averred the Finance Member, "are moving forward in fair unison and there is no need to fear, for the present at any rate, a lop-sided development with serious cleavages in interest." The downfall of France and the loss of continental markets caused some deterioration in prices but at the time of the budget of 1941-42, they were still 15 per cent higher than in September 1939. The general indices of progress like railway and postal traffic still showed improvement and the value of exports still ran at the old level. The Roger Mission on output of munitions, the Eastern Group Supply Council and the programme of placing supply orders two years ahead were described by the Finance Member as tremendous developments in the supply field which "must necessarily give a great stimulus to Indian industries." In presenting the next budget, he assured the legislature that "on the whole this country has been fortunate; the balance has so far been to her advantage."

It was when presenting his budget of 1943-44, two and a half months after Japan's attack on Pearl Harbour, that for the first time the Finance Member admitted some cause for uneasiness. "It would be idle to pretend", he said, "that in the last twelve months unfavourable factors have not gained relatively to the favourable ... Prices have risen and, as in other parts of the world, an increased money income is being expended on a smaller stream of immediately available goods." But with this admission in the earlier part of his speech, he devoted subsequent parts of it to disprove the existence of any inflation. In the light of what happened later, his arguments can now be regarded only as historical curiosities. The ceiling of the maximum utilization of available man-power and resources was not yet

reached and increase of currency was apparently the means, in the opinion of the Finance Member, to reach it! The impossibility of increasing the volume of commercial imports and the futility of any upward movement of exchange rate were held as another valid excuse for adding to the note circulation. Sterling balances in India's favour could not have any bearing on the internal problem which was to make disbursements in Indian currency. Since the only inflation which the Finance Member was willing to recognize was the inflation in the countries "which suffered utter defeat in the last war", the assured victory of the United Nations itself gave us guarantee against inflation! Indebtedness of the U. K. had been kept low while there were sterling debts to be repatriated and pure credit inflation had been avoided by making cash payment against "a block of investment waiting to be taken up by the nation". Finally, the rate of turnover of money was falling and in any case, high prices must require more currency to support them!

Yet in his budget speech of 1941-42, there had occurred this curious passage: "No one would wish to see repeated the period of hectically inflated prices which ruled towards the end of the last war, but we can rely upon steadily increasing industrial effort during the present one, with consequences which seem likely permanently to affect India's position among the industrial nations of the world." So, the Finance Member was aware of other degrees of "hectically inflated prices". But this was at a time when prospects of any inflation appeared remote. Nor was he altogether unaware of the duty which such inflation casts on the Government. When he presented his budget of 1942-43 amidst "favourable conditions", he stated the problem in the following words: "Nevertheless, it is beyond dispute that a stage has been reached at which in addition to the ordinary process of taxation, it is the clear duty of the Government to make a beginning with measures of a kind which will assist in relieving the pressure of enhanced volume of purchasing power on the inevitably limited supplies of goods and services which are available for private consumption at the present time."

In the budget of 1944-45, the Finance Member casts off any pretence. "Whether we approach the matter from the viewpoint of building the new India of our hopes, or from

mitigating the hardships of the immediate present, it is clearly our paramount duty to deal first with the menace of inflation." So ran his new revelation. Among the "resolute measures of a two-fold character launched by the Government in the monetary field and in the sphere of control of commodities", he listed all-India statutory price control of foodstuffs, cloth control, release of woollen clothing from defence requirements and the Hoarding and Profiteering Ordinance. For the rest, his fiscal measures were devised to close the gap estimated at 250 crores between the total of our taxation and borrowing on the one hand and the total of rupee outgoings on the other.

Inflation or Loans ?

The annual visible monetary savings and investment of India progressed at a rate of approximately Rs. 100 crores during the decade 1921-1930. During the five years 1939-1945 the accumulation rate appears to have exceeded Rs. 250 crores. While during the earlier years, precious metals claimed more than a third and the permanent public debt about a quarter of the annual savings, the War has enabled bank deposits and public loans to oust almost every other visible form of holding savings like precious metals, post office savings and certificates, scrips of joint-stock companies, insurance, etc. The public debt of India absorbed more than half of the visible investment funds and bank deposits a little less than a half.

The story of how this growth in the volume of monetary savings took place and how public debt and banks appropriated five-sixths of those savings is very simple and may be told in non-technical language in the following manner. Between 1940 and 1945, England and her Allies purchased goods for use in or outside India to the monetary value of about Rs. 1400 crores. During the same period, India also financed her War expenditure which was in excess of her revenues by about Rs. 500 crores. To facilitate the acquisition of sterling, the currency law was suitably amended so as to remove the existing restrictions on the volume of sterling assets the Reserve Bank was permitted to hold against note issue. Unable or unwilling to offer in return any goods or capital assets, the Allies could have paid for their purchases from individuals only by means of loans raised in India. Similarly, having exceeded its income

resources, the Government of India could finance itself only by loans in the same manner. It would now be futile to discuss why the British Government did not assemble and offer British investments in India as in the United States or why the Indian Government did not adopt more drastic measures of taxation including a war-time capital levy. Actually against the aggregate liability of about Rs. 2200 crores, the Government of India on whom fell the responsibility to find domestic finance for both the expenditures, could not raise public loans of more than Rs. 800 crores. Of course, these figures of Rs. 2200 crores and Rs. 800 crores must not be taken in the absolute sense because they are what they are only on account of the inflationary means adopted to fill the gap. What is important and relevant is the proportion between expenditure requirements and available means which they roughly indicate. The Indian authorities met the disproportion by accepting the mere paper promises of England called the sterling holdings of the Reserve Bank of India to the extent of about Rs. 1220 crores and issuing currency notes against them to the extent of Rs. 1000 crores. Over and above this direct expenditure, the net purchases of foreign countries through the regular channels of trade amounted to more than Rs. 300 crores. As notes were issued from week to week and month to month, the rise of prices caused a simultaneous growth both in the value of Allied purchases and the need to issue more currency notes. The goods supplied to the Allies came ultimately out of the consumption of those people whose incomes fell in purchasing power on account of rise of prices. It was a forced loan from classes who could least afford it.

The rise of prices approximately in the proportion of 100:250 raised money incomes, which in the ordinary course of things should have raised monetary savings in about the same proportion. But the rationing and price control of certain goods as they came into force for one commodity after another no less than the non-availability of certain other goods curtailed ordinary opportunities of expenditure and thus reinforced the normal influences which create savings. The volume of savings tended thus to swell still further. At the same time, legal or administrative restrictions or prohibitions altered materially the normal channels into which the community directed its savings.

New capital issues were licensed and house-building and imports of precious metals came practically to a standstill. The way was thus apparently cleared for canalization of all savings into bank deposits or public loans but for the fact that there were still pre-existing assets like land and the operation of heavy taxation, excess profits duty and above all black markets had already created a new rival to bank deposits and public loans, namely, currency hoards. The size of these hoards must have in the aggregate reached impressive dimensions because as against a rise in the note issue from less than Rs. 200 crores to about Rs. 1000 crores (i.e., a five-fold increase), the prices of both controlled and uncontrolled commodities and capital assets did not rise by more than $2\frac{1}{2}$ to 3 times the pre-War level.

Failure of Loan Finance

This inflationary procedure of war finance raises the question whether the failure to raise sufficient loans was unavoidable. During the more normal years, 1921-1930, when prices on the whole were sagging and there were no prohibitions on capital issues and no cessation of imports of precious metals or house-building, the public debt was growing at an average annual rate of about Rs. 25 crores. Precious metals and paid-up capital of joint-stock companies were absorbing on the average about Rs. 50 crores annually. In other words, at a much lower price level and without taking into account the much enlarged real national income during the thirties, these sources alone could have furnished Rs. 75 crores annually or Rs. 375 crores in five years. It is difficult to estimate the savings which were releasable from house-building which was then passing through a great boom. It is reasonable to suppose that investment in housing could not be much short of our annual consumption of precious metals. Thus against the price-inflated requirements of Rs. 2200 crores in five years of War, there is to be set our normal capacity to furnish without curtailment of ordinary consumption an output of Rs. 400 to Rs. 500 crores which at war prices has to be valued at not less than Rs. 1000 crores.

Apart from the identification of the public mind with a cause, the most powerful inducement to attract savings into public loans is undoubtedly the interest rate offered. It appears

that it was decided from the very first that the era of low interest rates amidst which the War started should be continued into the War itself, presumably in the interests of public borrowing. The decision by itself is not to be blamed, provided the implications of it were fully realized and translated into action. A particular level of interest rates for public borrowing is, however, appropriate and effective only when it is properly related to the returns on alternative investments. In England for example, the War was made a successful 2 or 2½ per cent war only because wholesale rationing and price controls created a volume of enforced savings, and over-all and drastic controls of profits and civilian output made alternative investments sufficiently unattractive. In India, rationing and price control arrived in a tardy and haphazard manner and could cover only a few commodities and, what is more important, only in a few bigger places. High income-tax, super-tax and excess profits duty introduced at a fairly early stage of the War appeared to hold down the profit level of trade and industry but, with output uncontrolled and low rates for loans and advances, profit margins were, as a matter of fact, twice and thrice as large as in peace times. When at length the Government awoke in the budget of 1944 to the need of more drastic steps, capital values had already doubled and trebled themselves. Moreover, land, the main outlet for investment in the rural areas, although growing more attractive to the investor because of the rise in prices of agricultural produce, remained altogether outside the range of the Central Government's power. While alternative investments acted in this manner as a magnet for public savings, low interest rates for public borrowings invited their own frustration by reducing the cost of liquidity and encouraging people to hoard resources in the form of currency notes and bank balances. It may, therefore, be truly said that the essential prerequisites of low interest rates were not adequately grasped and certainly were never fulfilled to the required degree in India. Whether the cause of the ultimate financial impasse is to be ascribed to the choice of a wrong financial policy or to administrative failure must depend on our judgement about the scope and potentialities of legal and administrative action in this country. In the abstract, the choice lay between over-all and effective controls and effective levels of interest rates for borrowing. In

actual practice, since large sectors of the economic system were bound in any circumstances to lie outside the range of Government's power, the proper policy for financing the War should have been on the one hand to raise moderately the rates of interest and on the other to take whatever measures were available to restrict and curtail returns on alternative investment. As the present writer observed on the outbreak of the War: "With a rigidly controlled foreign exchange market and a scale of relative demands furnished by a definite objective like the prosecution of War, interest rates in England have only a formal significance. With a largely uncontrolled economy like that of India, interest rates are a real and active force of regulation."

Indeed, India seems destined to pass through a quixotic phase of financial experience. During the years of War when higher interest rates could have moderated the degree of necessary inflation by inducing the public to subscribe to public loans and investment (such as was possible) required no stimulus of this kind, the country got the blessing of low rates. When the requirements of full employment and rapid growth should make in post-war years low rates very imperative, it is more than probable that higher rates will prevail in a struggle to hold in check the potential inflation implicit in hoarded currency and bank balances and, in the absence of a proper exchange policy, the trend to adverse trade balance implicit in an inflated price level. The pennies gained on the interest charge of public debt will have as their nemesis the pounds lost on the actual inflation of War years and the probable deflation of post-war years.

II

On the conclusion of the war in the West in May 1945 and in the East in August of the same year, the situation was bound to change materially. The actual course of events was, however, such as to falsify most prophecies.

Post-war economic trends fall into three distinct periods. From March 1945 to March 1946, prices continued to rise steadily and inexorably. The wholesale index number moved up from 247 to 293. From thence onwards till November 1947,

the level was on the whole stable between a narrow range of 293 and 302. Then arrived an anxious period of a few months when the index number began to mount in an alarming manner. From 302 it mounted to 383 in the following May-August.*

March 1945—March 1946

The continuation of inflationary conditions during these months of 1945-46 is hardly a cause for surprise. The favourable trade balance on private account was falling but still aggregated to Rs. 24 crores; inclusive of government and treasure accounts however, it was unfavourable. The sterling payments by the Allies for war expenditure in India ran into Rs. 342 crores. The Government of India's own expenditure exceeded its revenues by Rs. 123 crores, while its defence capital expenditure amounted to Rs. 35 crores. Against this total liability of Rs. 524 crores, the Indian Government could muster not more than Rs. 376

	(In Crores of Rupees)					Whole- sale Prices 1939 = 100
	Demand Deposits	Note Circula- tion	Cash of Banks	Reserve Bank Deposits		
				Central Govt.	Other Govts.	
1940 March	145	238	6.0	20	—	—
1945 „	604	1084	28.8	242	27	247.8
1946 „	703	1218	36.2	512	32	292.7
1947 „	690	1242	39.0	417	33	293.2
1948 „	670 (81)+	1304	36.8	257	20	340.7
1947 Nov.	651 (73)+	1199	35.5 (4.6)	369	17	302.0
1948 August	692 (20)+	1215	38.2	226	15	383.1

+ Demand deposits of Pakistan

crores in loans with a net increase in permanent indebtedness of about Rs. 304 crores.

The remaining gap between incomings and outgoings was covered by the issue of paper money which raised the note circulation by Rs. 134 crores. The addition to the volume of purchasing power in the hands of the public was much more, as this further issue of legal tender raised the demand deposits of scheduled banks by Rs. 100 crores more.

The rise in the price level was moderate in relation to the volume of purchasing power in the hands of the public. If the latter did not exert its full pressure on prices of goods, it was due to certain favourable factors called into action by the termination of the war. From the day of the close of the war in Europe, an unbridled optimism seized hold of the investment market of India. It is difficult to estimate the funds which were thus diverted into speculation or investment. Judging from the giddy heights at which investment scrips were changing hands, the volume must have been unprecedented. The general public also appears to have preferred a precautionary shift into liquidity. The time-deposits of scheduled banks which showed small progress during the war recorded an upward rebound of almost Rs. 75 crores. The small savings of the country which moved but at a slow pace during the war now increased by Rs. 62 crores—a rate of growth three times as high as during the six years of war. The close of the war caused unavoidably a fall in the rate of expenditure of the Central Government though not very quickly.

The general public and even experts feared a sudden deflation and counselled cautious dismantling of the apparatus of war. Even then, the deposits of the Central Government with the Reserve Bank rose by Rs. 270 crores.

March 1946—November 1947

The stability of prices during the next twenty months was the outcome of the receding causes of war expenditure and the gradual assertion of the forces of peace. The year 1946-47 had to record no expenditure to be financed on behalf of the Allies or defence on capital account. The trade balance inclusive of government and treasure accounts which was unfavourable to us in the previous two years continued unfavourable to the

extent of Rs. 40 crores and the Central Government revised deficit amounted to Rs. 55 crores.

The earlier part of the year 1946-47, was distinguished by a plentitude of funds in the markets. The Government took the opportunity to carry out a great conversion operation and, during the whole year, was able to raise its public debt by about Rs. 160 crores. The rise in the note circulation was only Rs. 24 crores from March to March which was probably accounted for by the difference between the two successive seasons. It is remarkable that the demand deposits of scheduled banks actually disclosed a fall.

It was during August 1946 that the investment market received the first check on the outbreak of riots and murders in Calcutta. But those who were encouraged by the premature abolition of E. P. T. and large conversion operations or allowed to indulge in the orgies of optimism by the criminal inactivity of the market authorities were not inclined to take much heed. They continued to feed and be fed by the prevailing fervour. In contrast with the demand deposits of scheduled banks, time deposits recorded a rise of Rs. 50 crores for the year 1946-47 and small savings were only a little behind with an increase of Rs. 47 crores. The volume of consumption expenditure was thus under fair restraint.

This general picture of falling war expenditure and growing volume of public savings, is somewhat marred by a tendency which began to disclose itself about the October of 1946. The new all-Indian Government at the Centre was besieged with demands for additional expenditure from all sides. For the whole period of twenty months, there took place a fall of Rs. 143 crores in the deposits of the Central Government with the Reserve Bank. But other favourable factors just described served to mask what was happening.

November 1947 onwards

Causes were, however, already at work to undermine the basis of this stability. Industry found itself between two fires—the mounting demands and strikes of Labour and the mounting fervour of the Government in proclaiming radical economic plans and policies. Strikes cost the country 12.7 m. man-days in 1946 and 16.5 m. man-days in 1947. The war years' average

was only 4.3 millions. Starting with the budget of the Interim Government, which should have entitled trade and industry to a respite of a few years, the investment market was subjected to a series of shocks like Nationalization Plans, Congress Economic Committee's Plan, Profit-sharing Plan, Limitation of Profits Plan, etc. Practical measures of immediate usefulness had no chance before distant, vaguely conceived ideals. The investor was filled with terror which was intensified by a creeping doubt from about August 1946 about the ability of the Government to maintain the uneasy low rates of interest. The already deteriorating situation was aggravated a thousand-fold by the events of the Partition which brought about huge losses of wealth, considerable unemployment and great unproductive expenditure out of public funds.

Even before the Partition, savings showed a tendency to evaporate. The year 1947-48 recorded an actual fall in the time deposits of scheduled banks. Small savings increased during the same time by Rs. 11 crores only. The evil effects of this tendency to save less were much intensified later when the uprooted people had to liquidate such wealth as they rescued to maintain themselves.

But for the new demands on revenues which were yet to disclose themselves the financial position of the Government was not uncomfortable.* The budget of 1947-48 foresaw a deficit of Rs. 6 crores only. It is true that the fall in the rate of savings and the changed psychology of the investment market were making borrowing extremely difficult. The yield on Government Security was steadily falling from March 1942 and for the 3 per cent loan, reached its lowest level of 2.84 in July 1946—the month of the cheapest loan ever floated in this country. With the August events in Calcutta, the yield began to mount and the yield of 3.03-3.05 for April-August 1948 reflected truly the change which had come over the capital market. But the liabilities of the Government were limited and

* *The improved budget position reveals itself on closer analysis to be more apparent than real. The distinction between ordinary budget and capital budget appears to have been availed of to smuggle inconvenient items from one category into the other. Started with good intentions it should not be surprising if financial jugglers abuse this practice with the same disastrous effects as in France.*

it met the situation by drawing heavily on the balances with the Reserve Bank. While repayment caused a fall in the Public Debt of Rs. 19 crores for 1947-48, the deposits with the Reserve Bank fell by Rs. 191 crores between March 1947 and July 1948.

The rate of withdrawal from Government balances with the Reserve Bank was on a somewhat bigger scale for the twelve months 1947-48 than for 1946-47. The main difference, however, lay in the fact that the previous withdrawal coincided with an improving rate of savings on the part of the public while the latter reinforced the effects of a deteriorating outlook on the future and a proclivity to save less and spend more on the part of all classes of people.

Significance of Government Expenditure

In order to appreciate properly the significance of government expenditure, it is necessary to bear in mind the vast change which has taken place in the volume of public spending relatively to the volume of national income and expenditure. In the pre-war year 1938-39, the total revenues at the disposal of the Central and Provincial Governments aggregated to about Rs. 168 crores. Although it is difficult to say what proportion this figure bore to the total national income or expenditure of that year it is unlikely that it was much above 5 per cent. According to the budget estimates for 1948-49 which exclude the Pakistan areas in the East and West, the Central and provincial governments shared as before almost equally in a total revenue pool of almost Rs. 500 crores. Looking to the changes in the level of wages of factory labour, or salaries or business incomes of individuals and joint families assessed to income-tax it appears unlikely that most of the money incomes in the

** National Income & Expenditure in Crores of Rupees*

	1938-39	1939-40	1944-45	1945-46	1946-47	1948-49
Central Govt.						
Revenues	84.5	94.5	335.5	360.5	—	255(bud)
Tax-Revenues	76.0	—	—	—	300(Rev)	266 „
Provincial Govts.						
Revenues	84	90	208	229	—	242 „
Central Govt.						
Deficits(—)		—482		—123	—55	

country are today much more than twice as high. The profits of companies assessed to income-tax reached a peak level of Rs. 168 crores in 1944-45 as compared with Rs. 47 crores in 1940-41, but profits are about a third of the total income assessed and are shared among a small fraction of the population. The expenditure of Rs. 500 crores by the governments of partitioned India exceeds by a large measure, perhaps by a quarter, the gross profits of businesses and companies assessed to income-tax in undivided India. If we take account of the deficits of recent years, the great importance of government expenditure is obvious. If the withdrawal from accumulated balances proves to be expenditure in addition to the disbursements from ordinary revenues, the pull of governments on the whole economy is bound to be very decisive.

The alarming rise of prices from November 1947 to June 1948 coincided with two significant occurrences. From about the middle of 1947, it was clear that controls on food and cloth were on the road to be lifted more or less completely. Secondly, November is the usual starting point of the busy season and not less than Rs. 100 crores were added to the note circulation till May and subsequently withdrawn during the slack season.

Decontrol by itself need not have caused a rising spiral of prices. Unless speculative funds receive a durable addition or the consumers' income and outlay are replenished, an initial rise of prices cannot sustain itself very long, or indefinitely. The seasonal expansion of currency might have aggravated the severity of the price rise but with the withdrawal of the seasonal issue this aggravating cause must have lost much of its force. During those fateful eight months from November 1947 to August 1948, the note-issue increased by Rs. 16 crores. This was a trivial amount compared with the total note-issue and was more of a reflex consequence of the release of government balances impounded in the Reserve Bank.

Apart from the vast resources released from ordinary savings, liquidation of accumulated investment and the release of government balances impounded till now in the Reserve Bank, the only other sources of funds must be banks or hoarded currency. It appears unlikely that hoards of currency continued in any appreciable volume after the demonetization ordinance of January 1946 and the frequent rumours of further demoneti-

zation. It is rather significant that the amount of 1000-rupee notes increased by a hundred crores between the outbreak of the War and the issue of the demonetization ordinance and that during the subsequent year the amount of 10-rupee notes rose by an equivalent amount. But these 10-rupee notes were more likely to be in circulation than out of it and the place of currency was filled very conveniently by gold and silver. The unwillingness of the war-rich to hold the precarious notes is no small element in the continuous spiral of prices of the precious metals.

From the end of the War till the end of 1947, banks were liquidating slowly their government security portfolios and replenishing their cash in the vaults. This was perhaps a precautionary measure against possible changes in the long term rate of interest. When prices began to rise in November 1947, banks seem to have found use for their accumulated cash. It is significant that while the note-issue shows a rise of only Rs. 16 crores, demand deposits of scheduled banks record an upward movement of Rs. 47 crores. The loans and advances of scheduled banks which began to recover from the end of the War improved further by about Rs. 75 crores. In those eight months, therefore, the Government and the banks between them made an initial addition of about Rs. 200 crores to the purchasing power of the public. Before it spends its force, an initial addition diffuses itself into a much bigger volume of purchasing power.

The time chosen for decontrol coincided therefore with: (i) the busy season when expansion of currency could not be avoided, (ii) a spate of central and provincial government expenditure which was largely unproductive or at best offered only delayed fruitfulness and (iii) a severe fall in the rate of savings investment and even actual disinvestment.

Fall in Savings

A substantial fall in the rate of savings or even actual disinvestment appears to have added materially to the fires of inflation. It is difficult to estimate the size of our annual savings and therefore the potentialities of expenditure from this source. It would be useful nevertheless to have even the roughest estimates on this head to enable us to assess the comparative importance of different forces at work.

Visible Savings (in Crores of Rupees)

Years	'21-30	'31-39	'40-45	'45-47	'47-48
Growth in Bank Deposits (March end)	—	55	570	212 ¹	54 ¹
Growth in Small Savings	50	60	24	108	11
Growth in Working Capital of Co-op. Societies	55	15	37	Not available	Not available
Growth in paid-up Capital and Reserve of Jt-Stock Cos.	120	52	—	Not available	Not available
Growth in Public Debt — Central (minus Govt. Security holdings of Banks) ²	180	33	458	412	—19
" Provincial "	—	—	31	13	—19
Premium Income of Insurance Cos.	70	120	82	46 ³	Not available
Growth in Precious Metals	350	—	—	—	—
Total	825	335	1202	791	
Annual Average	90	40	240	390	

During the five war years, 1940-45, the total visible savings aggregated to about Rs. 1200 crores which gives an annual average rate of about Rs. 250 crores. The actual volume for the last two or three years must have been much larger as there was

1. of which time deposits are Rs. 126 and 7 crores respectively.
2. applying the percentage of Big Five to total deposits minus Imperial Bank deposits.
3. assuming the same income as in 1945.

little inflation during the first two or three years and there was actually a fall in savings of certain kinds during these years. For the two years 1945-47, this volume of savings was much larger and may be placed at more than Rs. 400 crores annually. The estimates for war and post-war years are much more definite than those for pre-war years when house-building absorbed large amounts which could not be traced and recorded. The war and post-war years exclude an important item—the augmentation of the paid-up capital of public companies and what must be a much more important item, their aggregate contributions to reserves and depreciation reserves. Making allowances for these untraced items, it would not do much violence to human credulity to place the annual savings of post-war years at Rs. 450-500 crores per annum at the maximum. This estimate may be compared with the estimated pre-war savings of Rs. 200 crores.

There are two ways in which this part of the national income may be drawn upon for consumption expenditure. Those who normally save may decide to refrain from saving and use their income for ordinary expenditure or those who hold investments out of past savings can unload at prices which are attractive to those who have present savings and use the proceeds for consumption. The important point to be noted is that whether people decide to save less or to disinvest, the finance must come out of the current estimated savings of Rs. 500 crores and from no other source.

It is pointed out above that the year 1947-48 has no improvement to record in time deposits as against the additions of Rs. 50 crores and Rs. 76 crores in the previous two years. Similarly, it recorded an improvement in small savings of Rs. 11 crores only as against Rs. 47 and Rs. 62 crores for the two earlier years. Again, the public debt showed a fall of Rs. 19 crores as against additions of Rs. 169 and Rs. 303 crores in the same earlier years. The aggregate fall under these three heads alone may be equal to Rs. 250-300 crores. This fall cannot be explained by suggesting a fall in our national money-income during that year. Our money-income is probably on the increase—even after allowing for the fall in output which had undoubtedly taken place after 1945-46. It is also not possible to account for this fall by pointing out to any

increase under other possible heads of visible savings or investment. House-building has hardly received any impetus. In a time of rapidly rising prices, hoarding of currency does not offer even a plausible explanation.†

We thus arrive at the following picture of the sources of inflationary expenditure at the present time.

Source	(in crores of rupees)
(i) Central and Provincial Government expenditure out of Revenues	500
(ii) Central expenditure out of Balances	150
(iii) Volume of Savings	400
(iv) Sale of Assets and Investments	100
(v) Creation of bank Deposits and bank Loans and Advances	50-75
Total	1200 approximately

III

The Situation today

The situation before us today is briefly this: (1) The volume of savings has fallen appreciably. This is not due to fall in

	Time Deposits	Small Savings	Public Debt (minus small savings)
	(in crores of rupees)		
1940 March	109	135.3	592
1945 „	220	159.8	1412
1946 „	296	221.4	1715
1947 „	346	268.4	1874
1948 „	319	—	1855
1947 November	312	—	—
	(30)*		
1948 August	312	—	—
	(0.8)*		

* Time deposits of Pakistan

income levels. It has been caused by increased tendency to consume or even to be extravagant. (2) The volume of private investment has been negligible since the outbreak of the War. This is very largely due to our dependence on foreign supplies for capital goods. (3) The intensified propensity to consume and the arrest of progress in our productive capacity,† if not an actual fall, has raised the cost of living for several important sections of our community very much above their income levels. The distress caused by this disparity and the anger at the riotous living of the top “traders and business men” have undermined general willingness to work and made men look for remedy out of sheer despair to drastic economic and social changes.

Possible Alternative Policies

What are the possible alternative policies which we could now adopt?

(i) *Measures to stimulate private savings:* According to a recent estimate, the volume of our national income was about Rs. 4000 crores in 1945-46. We have estimated above our annual national savings at about Rs. 400-500 crores at present. The serious fall in our savings in 1947-48 and thereafter has been already indicated above.

Firstly, the present high level of taxation is too recent to permit sufficient time for the necessary psychological adjustment. New taxation—particularly at high levels—creates doubts about the virtues of saving and fears about still further depredations. Those who can save take time to be convinced that the ground under their feet is stable and that they can plan safely for the future. The obvious remedy for such a state of things is that the Government should adhere rigidly to the pattern of taxation they have announced and refrain from repeated changes or experiments in any direction.

Secondly, saving could be offered special inducement as against consumption. In order to frame proper inducements, it is necessary to have some rough idea at least about the exact sources of our national savings.

From the stand-point of these sources, our people fall into two large groups: (i) those who pay income-tax and super-tax

† A competent estimate places the need for renewal of our machinery and capital equipment at 40 per cent of our present productive power.

and (ii) those others who do not pay, either because they fall below the exemption level or because their incomes are derived from agriculture.

(i) What is the total income and therefore the capacity of the first group of people to save? Their total assessable gross income was Rs. 224 crores in 1932-33 and their number was estimated at 553 thousand. In 1940-41, their aggregate gross income was only slightly more and rose to about Rs. 480 crores by 1944-45, the latest year for which statistics are available. Our total national savings are estimated above at about Rs. 200 to 300 crores before the War and Rs. 400 to 500 crores after the War. If these estimates are not too wide of the mark, it is clear that our volume of visible savings is equal to the whole gross income of this group. In estimating the contribution of this group to our savings, we must make allowance for certain special facts. It is clear that the group consists of a very small number of persons with individual incomes far above the levels true of the rest of their countrymen. Qualitatively, their contribution is vital because investors in all modern trades and industries are largely drawn from this group.* The proportion of the income this group saves must be somewhat less because about one-third of its income consists of salaries which at the present cost of living cannot have a margin of saving above 10 to 20 per cent. Even if the rest saved 50 per cent of their gross income out of sheer incapacity to spend, the total volume of savings of this group in 1944-45 could not reach Rs. 200 crores and was probably round about Rs. 150 crores. Actually, a good fraction of this income now goes into payment of taxes.

The annual increase in the paid-up capital of companies and firms, fixed deposits of banks, buildings in highly urbanized areas, etc. is largely the objective expression of the savings of this group.

It appears from our estimates that the bulk of our savings is derived from the other group of our countrymen. Their savings run perhaps into Rs. 250 to 350 crores at present and are spread in small amounts over a very large number of people. The

* In a recent analysis of shareholders of 8 companies—Tata Iron & Steel, Apollo, A. C. C., Belapur, Scindia, Central Bank New India Assurance, Tata Hydro—it was found that 8 per cent of the shareholders held 60 per cent of shares. The analysis excludes holdings of blank shares.

objective expression of their savings is to be found very largely in small savings, Government Securities, houses in medium-sized and non-industrialized towns, gold and silver, etc.

The causes which have led the first group of people generally to prefer spending to saving are diverse. (a) In order to evade high taxation, trade and business have chosen to increase their expenditure in all manner of ways. If an inquiry were made into increase of salaries recently granted to certain employees and the caste, social or communal relationship of these highly paid employees to directors, managing agents, etc., the extent of this evil will become quite clear. (b) The income recorded in the income-tax returns is only a part of the real income of traders and business men. Controls and government regulations have created opportunities for and placed a premium on all kinds of illegal profits and incomes. Where these profits and incomes cannot be concealed, they are spent on extravagant living. This evil may have a counter-balancing effect. If expenditure out of illegal sources makes such persons show less expenditure and more saving in their income-tax returns, a certain mitigation of extravagance must be allowed for. (c) The existence of the Income-tax Tribunal and the consequent risk of exposure and punishment must be having curious effects on the disposal of concealed profits. Successful concealment must have immobilized quite a large spending and investment power. But it is also likely that fear of perpetual immobilization on account of an efficient Income-tax Department may induce gradual spending away of these reserves. The recent provision for compounding war-time evasion of taxes by agreed payments is unlikely to achieve much except in marginal cases.

The inducements to saving announced till now by the Government apply very largely to this group. These measures are special depreciation allowances, lower corporation tax on profits carried to reserves, special tax exemptions and depreciation allowances on new buildings, etc. The effectiveness of these inducements is somewhat marred by certain undecided points and measures running counter to them. It is not yet clear whether the ownership of reserves lies with the shareholders or is held in common by them and labour. The existence of Capital Gains Tax must tend to encroach to some extent on the profit

accruing to the shareholders on account of the improved financial strength of a concern. The practical value of depreciation allowances must depend on the basis on which depreciation is to be calculated. The prospects of heavy death duties or inheritance taxes is another factor which must tend to weaken the motive to save—particularly at the higher income levels.

It is clear that the inducements devised till now do not touch the problem as explained above. The inhibition of a high level of taxation raises several important points. As suggested above, the inhibition may be only a temporary phase pending the needed psychological adjustment. Even if reduction in taxation increased the volume of savings by more than the reduction—itself a very doubtful proposition—we shall have yet to answer the question whether funds in private hands will in the present circumstances be invested to better purpose than funds in the hands of the Government. As for extravagant expenditure to avoid taxes, the auditors and Income-tax Department should be in a position to report such cases to a special branch of the Industries and Supply Department of the Government. The prevalence of illegal incomes and profits is a part of the much bigger question of controls and cannot be judged apart from it. The Income-tax Tribunal relates to a specific period and therefore to the specific profits already made and unless it becomes a permanent feature of our tax system, its inhibitive effect must vanish with itself.

(ii) We must now turn to the other group which supplies probably the bulk of our annual savings. This group is very miscellaneous, the only common point among the classes of persons being the low or moderate level of their incomes. It consists of salary-earners below Rs. 2500-3000 per annum, labour in factories, urban and rural artisans, the peasant and agricultural labourer, money-lenders, etc. It would be impossible and probably futile to try to isolate those among them who can save and to estimate their saving capacity. Their volume of savings rests simply on the foundation of their large number.

We may take for illustration the only compact class among them, labour in recognized factories—organized labour, as it is sometimes described. The numerical strength of this class was about 17 lakhs at the outbreak of the War and it now stands at about 24 lakhs. In 1946, the total wages bill for 20 lakhs among

them stood at Rs. 112 crores and on that basis, a labour force of 24 lakhs should have a wages bill of Rs. 134 crores. Since 1946, labour has achieved certain further improvements and it is probable that the wages bill of this class lies today near Rs. 175 crores.* Even with all members of the family in gainful employment and with their habits as they are, their saving is not likely to exceed 10 per cent of income. The urban and rural artisans, agricultural labour and the bulk of the actual tillers of the soil are certainly not better placed than these factory labourers. It appears reasonable therefore to infer that the bulk of the savings of this miscellaneous group ensues from salary-earners, money-lenders, more well-to-do farmers, land-owners, and professional persons.

Till some relief was given in 1947 and thereafter, the salaried classes were ruthlessly squeezed between rigid incomes and soaring cost of living. Even in the case of those above the income-tax limit, the total income assessed was about Rs. 70 crores in 1940-41 and only 92 crores in 1944-45, the increase being largely due to expansion of employment. The condition of those below the income-tax limit is unenviable even now. More than any psychological inducement, what they need most is restoration of their saving capacity by a fall in the cost of living. Passive victims of their soaring cost of living, they have contributed nothing to the inflation except for any disinvestment due to the same cause.

Among the middle-classes, the numerically small professional section has risen to be the "New Rich". They must be classed, with traders and business men, among the beneficiaries of war and post-war inflation. They are covered by the income-tax returns of income and assessment.

It is difficult to speak of farmers and peasants—the bulk of the country's population. Those among them who cultivate food-grains or even commercial crops on a subsistence scale have hardly improved their economic status. Others, who form a small fraction of their class, have probably repaid the bulk of their debts—which means a flow of liquid capital into the hands of rural traders and money-lenders and explains partly

* On the basis of Bombay Province statistics for 1947, the all-India average yearly earning of factory labour should be 271 per cent of the average yearly earning for 1939, that is, about Rs. 813.

rural hoarding of goods and commodities. The volume of savings of these classes must be considerable in the aggregate and may be very sensitive to psychological inducements.

Interest Rates: An advance in interest rates may be suggested as a remedy for this fall in savings. Such an advance must be judged from different angles.

(a) It is probable that the present returns on savings fall short of the required level for inducement to save. This would be particularly true if the return on government securities, fixed deposits or savings deposits is discouragingly lower as compared with returns on other forms of investments. So long as controls prevent the necessary adjustment between the volume of purchasing power in the hands of the public and the price-level, an artificial plentitude of funds ensues and enables purely money rates to be kept low. But when purchasing power and price-levels move towards adjustment, the surplus funds are no longer surplus and real rates of interest assert themselves. In this case, an advance of interest rates means nothing more than conformity to the supply and demand conditions of capital and is a prerequisite to the proper functioning of the economic system.

We must therefore answer the following questions. Will an advance of interest rates induce all classes of people and particularly the second group of people to save more? Is there at present a wide disparity between returns on forms of investment preferred by the second group as compared with other forms? If the returns on other forms of investment are appreciably higher, how is this fact to be reconciled with falling values of such investments? Finally, with the index number of prices at the level of 380-390, could it be said that the volume of purchasing power and prices are adjusted to each other?

(b) An advance of interest rates may be desirable not only as an inducement to save. By making money dearer, it may initiate deflation and a fall of prices. We shall consider in its proper place whether a fall of prices brought about by this means is appropriate and desirable in the present situation.

The figures tabulated overleaf indicate the following trends: The yield on Government Security has been steadily rising since July 1946. As for returns on industrial investments, it must be remembered that most individual dividends clustered round the lower figure during 1926-36 and the higher figure during 1937-47

	1939	1940	1941	1942	1943	1944	1945	1946	1947	1948
<i>Net Rates of Interest accruing to Insurance Companies</i>										
<i>Indian</i>	4.68	4.37	4.17	3.94	3.88	3.61	3.48	-	-	-
<i>Non-Indian</i>	-	-	3.68	3.50	2.79	3.35	3.22	-	-	-
• <i>Government Security</i> <i>3.5 per cent</i>	-	-	3.68-3.65	4.01 (March)	-	-	3.39 (Nov)	-	-	-
<i>3 per cent</i>	-	-	-	-	-	-	3.08 (July)	2.84 (July)	-	3.05-3.03 (Aug)
<i>Fixed deposit Rates</i>										
<i>Imperial Bank</i>	1.5	-	-	1.5						
<i>Punjab National Bank</i>	2.875	-	-	2.5						
<i>Average Dividends per cent.</i>										
<i>Highest & Lowest :-</i>	1926-36	1937-47								
<i>Cotton Industry</i>	24.6 7.6	40.3 8.6								
<i>Jute Industry</i>	72.0 15.7	21.6 7.3								
<i>Sugar</i>	21.3 11.0	17.0 9.0								

* In this case, the interval between two dates represents continuous rising or falling movements

The yield at present prices works out for most of them between 4 and 8 per cent. The fall in the values of these investments must be ascribed to doubts firstly, whether industry could maintain its profits at the present level, the present trend being distinctly lower year after year, and secondly, whether the Government could maintain interest rates at their present levels, the trend being towards greater scarcity of money year after year and greater adjustment of prices to the volume of purchasing power.

Fall in Volume of Investment

It is difficult to say whether there has taken place any measurable fall in the volume of investment. During the War, all surplus funds went into government loans for purposes of war. Even after the War the obstacles to the acquisition of capital goods and basic raw materials have continued to the same extent. The applications for capital issues and the consents given are an index only to plans of investment and not to investment itself. We have no statistics of capital paid-in and even if they were available, they could indicate only the liquid funds seeking investment. So long as capital goods do not flow in and basic raw materials are not available freely, willingness to invest or absence of it has little effect on actual investment.

The collapse of investment values is sometimes suggested as a deterrent not only to investment but also to saving. It is not clear why depreciation of equities, etc. should affect the volume of savings itself. If investment becomes risky, savings will tend to be kept in a liquid form—in fixed deposits, short-term government securities, current-balances, etc. Unless people are persuaded that no investment is possible today or in the future, there is no reason why the volume of savings itself should fall off on this account.

If the volume of investment shrinks and funds are kept in liquid forms, this should act as a deflationary force. Fall in the volume of investment means fall in incomes and ultimately a downward pressure on employment and on prices. There is certainly no evidence of such a trend.

A depressed outlook on the prospects of investment has a significance for the future when investment starts in earnest. So long as that day is far off, this depressed outlook can affect the value of only existing scrips. It matters little for the present

functioning of the economic system whether these values are high or low. A fall may even be salutary because it automatically reduces the temptation or the power to liquidate and spend. The only precaution about which the authorities have to be careful is that this depressed outlook should not persist or deepen till the day of resumption of investment. If the authorities adhere to the pattern of a fixed policy, the present gloom is sure to work itself out in due course of time.

The fall in equity values might even prove salutary and a much-needed initial preparation for healthy investment. The present bear phase of the investment market is the outcome of two forces. Firstly, the unbridled speculation which started at the end of the War was not in any manner checked or counteracted by the market authorities. This speculation was reinforced but was certainly not caused by the imprudent abolition of excess profits duty, and cheap money policy and conversion operations. No one in his senses will believe that the absurd equity values which prevailed before August 1946 could have ended in anything but disaster. If the market authorities had during the tremendous boom taken measures similar to those which the Bombay Stock Exchange introduced after the Liaquat Budget, the boom and the collapse might have been much less severe. The second factor which is responsible for the debacle in the investment market is a series of events—strikes of labour and public utility employees, the Calcutta riots, the Liaquat Budget, awards of industrial courts, Partition outbreaks, organized bear raid in January 1948, publication of the Congress Economic Committee's Policy Plan, another organized bear raid following the Shanmukham Chetty Budget, ministerial unauthorized and quite unnecessary utterances from time to time—to mention the most outstanding in a roughly chronological way. This record of events, it will be observed, centres largely on government policy which was never devised or presented as a consistent, well-defined whole but was thrown out at trade and industry in haphazard ejaculations.

The Government must accept a large share of the blame for the present plight of the investor. But, whatever the excuses or provocations for the landslides of the stock-markets, the revision of equity values to conform to post-war costs and profits was an absolute prerequisite of healthy investment. The mistakes

of the Government could at the most have hastened prematurely this inevitable and necessary adjustment. The Government has now before it a valuable interval of time before private investment starts with any appreciable earnestness. It will be wisdom on its part to make use of this respite to devise proper, permanent reforms for the investment market and joint-stock enterprise so as to avoid the scandals of the last few years. The fiasco of the Stock Market inquiry instituted in 1944 which culminated in an astounding document has a lesson for the Government not confined exclusively to this sphere as such. It is yet to be proved that the Government has even an awareness of the lesson.

Although in general there is an enforced limited scope for private investment, there is one possible exception. House-building should evoke no little eagerness in all areas—urban or rural—if it were not held up by the obstructions implied in all controls. If Government retired from this field and allowed raw materials to be obtained freely, the pent-up investment enthusiasm might find a healthy outlet. But controls and transport bottlenecks must be cleared out of the way first.

Public Taxation, Expenditure and Investment

In a phase of falling savings, increasing consumption and limited private investment, what function could public expenditure and investment assume?

It is indeed obvious that the Government must reduce or bring to a halt all unproductive expenditure. "Unproductive expenditure" means in this context expenditure which adds to the demand for consumption goods without much prospect of adding to their output. The Government must also curtail all long-term investment which leads to immediate disbursements of incomes but much delayed fruit in the shape of commodities.

With the trend of private expenditure to increase and limited private investment, reduction in taxation or borrowing appears to be out of question. There appears, indeed, to be a strong case for increase but for certain obstacles. The present level of taxation of certain classes of incomes seems to have reached its maximum and is perhaps already affecting adversely the incentive to produce. For further increase in taxation we must seek out other classes of people. Income-tax on agriculture

or duties on inheritance offer a certain scope. Taxation of luxury-consumption already introduced by the Government has but little scope as the use of luxuries is confined to an insignificant fraction of the population.

Borrowing or alternatively a compulsory levy in return for Government bonds is suggested as another remedy. A compulsory levy has some justification only if it could be proved that people prefer to keep their cash liquid, rather than offer it to the Government. Even liquid cash is to be encouraged if it tends to reduce private expenditure. The main question to be answered is whether borrowing or compulsory levy will in any manner touch the funds which people are inclined to devote to expenditure. Unless the incentive to lend is very high or compulsory levies reach impracticably high levels, it seems highly improbable that the volume of expenditure will fall. The only usefulness of such measures should be that the Government is likely to use these funds to better purposes than private persons are now doing.

With such new taxes as are feasible, the present volume of taxation of Rs. 500 crores should be maintained and by curtailing expenditure, a growing surplus should ensue. With this surplus and the sterling at the disposal of the country under the Sterling Agreement, the Government should have quite a large margin for investment. If the sterling were used for acquiring the needed materials abroad, this should relieve to an extent the present pressure on local supplies. If the Government acquired all the iron and steel it requires from abroad, the decontrol of these goods to stimulate house-building could be expedited.

Disparity between Incomes and Cost of Living

We have two alternative choices before us. The first choice would be to accept the present price-level and cost of living as established facts and to allow incomes to rise to their level. Such a policy would still mean a grave injustice and hardship to all those who hold accumulations of the past. This is a very serious consideration in a country composed of such a large element of persons with moderate incomes, especially the middle-class. All insurance policies, provident funds, etc. created before and during the War must in this case fall to less than half their expected value. Besides, although the principle of a

Prices and Cost of Living (August 1939=100)

	Wholesale Prices				Cost of Living				Average Earnings of Factory Labour	
	Food	Raw Materials	Miscellaneous	General	Bombay	Sholapur	Kanpur	Jalgaon	All India Rs.	Bombay Province Rs.
1946-7	270	352	—	—	252	303	338	—	619	—
Nov. 1947	294	377	460	302	273	362	413	—	813	1013 (271% of pre-war)
Aug. 1948	—	—	—	397	321	306	—	434	—	—
Sept. 1948	396	435	531	382	323	309	—	437	—	—

particular average increase is accepted, the adjustment of relative wage-rates, etc. will not be less difficult than the achievement of the average itself. For the Government, it will mean a very serious reshaping of the whole structure of taxation and expenditure.

The other choice is to reduce the price-level and cost of living to somewhere near their post-war mark. A controlled fall in the index number from about 400 to about 250 is not an easy task. Whether such a fall will settle the issue of class relations must depend on the means employed to bring about this fall. The fall by itself does not assure justice on this point though it means relief of immediate distress.

(a) The immediate removal of the causes of the recent inflation is only a first step. The accustomed rate of saving may be restored. The Government may halt its present unproductive expenditure and even create a surplus. In an expanding economy, this might have been sufficient by itself to cause not only a halt to rising prices but even a reversal of the trend. In a stagnant economy where productive power is hardly even maintained, the chances of any appreciable fall are very limited.

(b) Another means which suggests itself naturally is increase of output. With 1939 equal to 100 for the output of our industry, the highest level reached was 126.8 for 1943-44. Today the index number stands at about 107. It appears therefore, on paper at least, that there is some margin for raising industrial output. But the scope for increase is not as large as these figures indicate since we have to allow for special war effort, subsequent wear and tear of equipment, etc. If we recall that agricultural output must also be reckoned, the aggregate war-time improvement will be much smaller and the possibilities of present increase much more slender. It is difficult indeed and hardly feasible even to estimate the increase in output which could bring down prices from 383 to 250. It is important to remember, however, that in 1943-44 when the industrial output index number was the maximum at 126.8 and the price-index number was at 236, the note circulation was Rs. 882 crores for the whole of India. Today the note circulation for India minus Pakistan is Rs. 1254 crores. If the price-index number were sensitive to industrial output as such, the present note circulation alone would justify a price-level of much more than 335. Apart from over-simplification which such calculations unavoidably in-

	1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46	1946-47	1947-48
National Income (in crores of rupees)	1,934	2,058	2,336	3,373	4,233	4,270	4,238	—	—
Index Number of Industrial output (<i>Eastern Economist</i>)	110.3	114.2	123.2	125.5	126.8	121.7	120.0	105.0	107.6
Labour in Factories—Perennial (in lakhs for calender year)	14.5	15.4	18.4	19.8	22.4	28.1	26.4 (24.8)*	23.1*	

* Excluding Punjab & N.W.F.P

volve we have to allow for the fact that in 1943-44, the demand for war requirements was at its greatest while now the whole of this output is available for civilian consumption. We must not overlook also the reduction in the hours of labour, number of shifts, the transition from war to peace psychology, etc. The increase of output should lower the price-level somewhat below what such calculations indicate.

From the standpoint of output what we are up against is not a mere economic deadlock but a far more serious psychological deadlock also.

Labour resents advice to increase output as a device very largely to increase profits. The answer of the Government is a succession of ill-examined or half-examined proposals—profit-sharing schemes, a dividend limitation measure, share in industrial administration, promises of nationalization in the future, etc. The advanced sections of labour feel that to increase output is to give a fresh lease of life to the old system and that the world-wide trend in economic ideology will not be recognized by the other parties except under compulsion and obstruction.

The initiative of the "Capitalists" ended with the publication of the Bombay Plan. They are now paralysed by uncertainty—uncertainty about profits, taxation, ownership of industry, control and management of industry and, perhaps in some instances, the fate of profits from tax-evasion and law-evasion. The uncertainty is caused only partly by confused counsels in the Government. It originates much more in their psychological inability to accept a new economic order as an inevitable, even if unpleasant, fact and to take initiative accordingly. The answer of the Government to these fears is tax-exemptions, tax-reliefs, depreciation allowances, stabilization of profits, vain attempts at joint and agreed decisions on disputed points, compulsory arbitration, more vagueness about nationalization, etc.

When a psychological deadlock of this kind is reached, it means two things—either capitalism must be given up as a working system or Government, Labour and Business must reach an agreement on all heads which the State will enforce with all the power of law at its disposal. It is worse than futile to deal with the situation in a piecemeal manner. It is much more dangerous to announce intentions in advance of detailed examination and positive adoption of plans—particularly when the

intentions relate to dates as distant as five or ten years. When one party to the economic system refuses to recognize that its basic presumptions are breaking down fast, another party is bent on destroying it by sabotage and the Government cannot rise above the level of amateurish ideas, it is only a question of time when all will be involved in a common ruin.

Effects of Advance in Interest Rates

The classic weapon for deflation and fall of prices is an advance in the interest rates and other supplementary or reinforcing measures. Could an advance in interest rates be trusted to bring about the desired fall in prices and cost of living? To answer this question, we must bear in mind how exactly advancing interest rates bring about their expected effects. Advancing rates (i) reduce the volume of credit offered—particularly by banks; (ii) increase the expenses of production, particularly in those lines which employ much capital relatively to labour and thus force a contraction of business; and, most of all, (iii) by deterring further investment, bring about a fall of incomes and therefore of prices as well.

(i) As for the effect of advance of lending rates on supply of money and particularly credit, the issue is not without serious doubts. It is true that a substantial deflation of the large volume of notes and deposits holds out greater assurance of fall of prices than any other means. But bank credit is a relatively smaller source of funds in this country. It is not improbable that in case of a squeeze on bank loans, funds will be drawn out of other sources. It is possible to support advancing rates by sale of Reserve Bank investments and withdrawal of funds from the market. But a prolonged period of inflation is hardly favourable for accumulation of investments by the Central Bank and the ammunition might well run out before the first phase of the battle is over.*

(ii) As for increase of expenses on account of higher rates,

* *Reserve Bank of India Investments (in Crores of Rupees)*

1940 March	9	1947 March	58
1945 ,,	17	1948 ,,	73
1946 ,,	31	1947 November	96

1948 August 55

the scope for action is limited only to stocks of manufactured goods. The main stocks to be held in this country consist of agricultural produce and the output of these commodities is hardly sensitive to expenses of holding stocks. Higher rates will be passed on in smaller prices to the producer once and for all. The fall of prices is not likely to be appreciable and it is not even certain that with the present obstinate scarcities, increased expenses may not be passed on to the unfortunate consumer in higher prices.

(iii) The main effect of advancing interest rates should be felt on the volume of investment and income. On an economy which has capacity for expansion, the inhibitive effect is large and instantaneous. Unfortunately, we have to deal not with an economy in which investment is active but with a stagnant economy. Advance of interest rates will cause depreciation of existing investments. Such depreciation means no change in output capacity. Beyond that, it will achieve very little by way of increase of output.

Resistance to advance of interest rates springs sometimes from a cause different from those discussed till now. It looks like a breach of faith with those who subscribed to loans during the War at continuously falling rates. If necessary the objection could be met by revising simultaneously the rates allowed on all such war loans till now. The burden on the Public Exchequer should not exceed one per cent on the average or one crore of rupees on a total indebtedness of 100 crores. In a total budget of about Rs. 250 crores, it should not be difficult to find Rs. 5 crores for this purpose. A good part of the increase in interest will probably flow back into the Exchequer *via* income-tax and super-tax.

As made clear earlier, an advance in the interest rates has to be assessed both as an inducement to save and as a means of restraining prices. The foregoing discussion makes it clear that its capacity for deflation is, in the present circumstances, very little. A fall or a rise has little relation today to our productive capacity. But as an inducement to save and refrain from consumption, an advance in rates may have quite notable results.

Start to Investment

From our discussion till now, one fact stands out very

prominently. Normal correctives to our economic difficulties are not appropriate because our economic system is not functioning in a normal manner. Neither in our trade relations with the rest of the world nor in our trade relations among ourselves, does a higher price for a commodity bring forth its proper supply. We have reached a state of economic deadlock. In this deadlock, the most significant factor is the standstill nature of investment. Savings have to be encouraged not merely to draw away purchasing power from consumption but also in order that they should augment our productive capacity. Efforts have to be made to raise the output of existing equipment but the margin for raising the output is not large unless we invest and add to the equipment. Changes in interest rates have ceased to function because the volume of investment has ceased to be elastic. The investment market has ceased to have a positive function because though savings may be forthcoming for new enterprises, they must remain in liquid forms for want of the necessary goods and equipment. Some effective measures must be taken to start the normal processes of investment.

In the altered circumstances and ideology of the times private investment and public investment have both to play important roles. Whatever the actual decisions on the points of dispute about them, care must be taken that the aggregate volume of investment remains at the desired level and progresses at the desired rate. Until the investment mechanism starts to function it is idle to raise paper controversies about our ultimate ideals.

What are the causes which have brought to a halt private investment? (i) There is first the inability or unwillingness of the highly industrialized countries to supply capital goods. Offer of a higher price is today not sufficient to attract the needed goods. Most countries have imposed physical controls to assure priority for their own rehabilitation. Trade-agreements and currency practices fix arbitrarily the channels of trade. It is clear that we must exert all our bargaining power to secure the satisfaction of our immediate pressing needs, not only of equipment but also of personnel.

(ii) A factor which repels investment is high prices of capital goods and high labour costs. Capital goods are reported to be three times as costly as they were before the War. Measures have to be devised to counteract this obstacle. Trade

and industry must be enabled and encouraged to provide for depreciation on a scale which protects them against this dead weight. Mere allowances in taxation are not enough. The basis on which depreciation is to be calculated on invested capital is important. If capital goods are three times as high, the basis should be at least $2\frac{1}{2}$ -3 times the pre-war book value. On new capital goods installed, some depreciation fund must be created before taxation is levied on gross profits. The other obstacle is largely psychological. If capital avoids investment because of high prices, it must be due to an expectation that present prices are abnormal and will not last. This psychology is incapable of direct treatment except by creating some insurance along the lines just now suggested.

(iii) It is to be feared that controls on basic industrial raw materials are not a little responsible for the stalemate even in lines in which scope for immediate investment does exist. Housing is the most important issue at stake here. Before the War half, perhaps even more than half, our savings went into this form of investment every year. According to the location of the place, the raw materials of house-building are very varied and capable of very wide substitution. But so long as controls exist, iron and steel, cement, timber, etc. cannot reach the right places and the right hands. Some of these materials are in short supply but it is better that they should be freely available than that they should have to pass through a series of parasites before *bona fide* persons can obtain any supply at all. Certain suggestions will be made presently to relieve the pressure on these supplies.

If private investment does not show signs of life and savings accumulate or are enforced, the case for public investment is very strong. While the resumption of the normal rate of saving will exert a downward pressure on prices, public investment will reinforce it by adding to the output of those goods which are deemed vital in our present situation. As public investment is hardly likely to encroach on or run along competitive lines, the risk of depreciation of investment does not exist. It is true that the public will have to pay for the high construction costs but against it must be set the fact that a planned investment over some years might put heart into private investment by assuring demand for certain goods for a period.

The Government would do well to secure from abroad supplies of goods of which there is shortage here. Such a policy will achieve two things. The local shortages will not be aggravated. Secondly, the balances which are allotted by the United Kingdom for the next few years would be fully used without the necessity of parallel monetary measures here. Even if the cost of foreign materials is relatively higher, compensation will be reaped on the cheapness of domestic investment in the private sector.

IV

Immobilization of Purchasing Power

We have examined now several means to deflate present high levels of prices and cost of living. In every case—halt in public expenditure, further taxation and creation of surplus, increase of output, advance in interest rates, impetus to private and public investment—we encountered stiff obstacles. A moderate but steady and determined application of every one of these remedies should in course of time bring about some mitigation of present conditions. But will such non-spectacular exhibition of economic common sense be sufficient to the needs of the situation? According to certain persons, direct immobilization of purchasing power and perhaps its gradual release offers a drastic and immediate solution of the problem.

Before stating and examining the wisdom of possible measures in this direction, it is well to bear in mind one crucial warning. A mere fall in prices and cost of living is not the sole object we should aim at. An equally urgent and, from the standpoint of our permanent progress and welfare, much more important need is to assure increase of output and a proper functioning of the economic system both in the public and private sectors. Measures which offer immediate prospects of fall in prices but at the same time deepen and complicate our present economic deadlock are not to be adopted light-heartedly.

Possible Remedies

The measures likely to achieve immobilization of purchasing power are stated below in the order of increasing severity.

Every one of these measures requires very careful con-

sideration and scrutiny. It would be of little use to embark on a full discussion here when the question of remedies is still on a hypothetical plane. The difficulties to be faced are grave and enormous. The best wisdom in a complicated economic structure like ours would lie in avoiding dependence on any particular remedy or set of remedies, and putting into effect simultaneously all possible measures for relieving the situation. A few general observations are all that is sought to be recorded here.

(i) *Enforced margin for bank loans generally and against particular commodities*: This remedy presupposes a much closer contact between the Reserve Bank and the commercial banks than exists at present. There is possibility of evasion by collusion between the banks and their clients as to valuation or ultimate destination of a loan. It may create a black market in loans. Some banks will be adversely affected in their profits.

(ii) *A variable proportion of deposits of scheduled banks to be compulsorily deposited with the Reserve Bank*: This remedy is already in operation in the U. S. A. The actual arrangement links this proportion not only to the volume of deposits but also to the turnover of deposits. The limitations of this arrangement should, however, be borne in mind. The volume of checkable deposits is only about a third of the purchasing power in this country. Secondly, business is able to raise a very large volume of funds from outside the banks and at rates which are more favourable than the lending rate of banks. If the profits of banks fall it might cause some harm to the position and status of certain banks.

Alternatively, it is possible to empower the Reserve Bank to issue its own debentures or in other words to increase its volume of investments at will and unload it on the market. The procedure has this advantage over Government loans—there arises no question of the employment of these funds. The Reserve Bank whose income is inflated by issue of notes has to bear automatically the burden and penalty of deflation. This remedy has not yet been adopted anywhere.

(iii) *Full freedom of imports and withdrawal of all notes to the extent of any adverse trade balance against payment of sterling abroad*: This would mean abandonment of the idea of curtailment of unnecessary consumption and of creation of enforced

savings. It must be remembered that in the absence of investment, such enforced savings mean hoarded currency or purchase of existing investments and durable goods at continuously inflated prices or expansion of working capital, which in the absence of increase in labour or raw materials, adds to the general inflation. It is to be feared that most of the war savings have been wasted in this manner.

This remedy is limited by the sterling, soft currencies and hard currencies available within the respective areas in addition to our exports to them.

(iv) *A controlled but higher exchange rate to stimulate imports and cause a check on and fall of prices of export goods:* The use of the weapon is limited by the degree of fall in our essential exports and the availability of foreign currencies which might be aggravated by the fall in exports. It conflicts with our obligations towards the I. M. F. and in the present circumstances might provoke export controls and other retaliations.

For 1946-47, on private and Government account, our imports stood at Rs. 330 crores and exports at Rs. 320 crores. The total visible balance of trade inclusive of treasure was Rs. 40 crores against us. For the previous two years, the adverse balance amounted to Rs. 26 crores and Rs. 33 crores respectively. Even after March 1947 the trade balance is against us on the whole, though the figures are not comparable on account first of the exclusion of Pakistan altogether since August 1947 and later its inclusion among foreign countries after July 1948.

A controlled high rate is at best a temporary expedient. The higher it is, compared with domestic and foreign price levels, the more difficult and tardy must be the return to free commerce and equilibrium rates. It is more than probable however that the day of normal conditions is very distant and the freedom which was permitted to France might be claimed with equal justification by India.

(v) *Surrender of all or selected British assets in this country and their sale against accumulated sterling balances:* In the prevailing circumstances, the release of sterling and the acquisition of British assets must be treated as alternatives. This step might facilitate the nationalization or part nationalization of certain industries. But the main object should be to offer an outlet to

savings wasted at present. If the offer of these investments stimulates savings, to that extent inflation will be counteracted.

(vi) *Acquisition of gold and silver against sterling balances and sale in this country*: This is primarily a question of sterling releasable by the United Kingdom or available dollars. The effect on inflation depends on the extent to which it stimulates savings. Offer of British investments is a better alternative than the sale of gold and silver.

(vii) *Special graduated levy on incomes*: This has been already considered earlier.

(viii) *Nationalization of gold and silver stocks in the country and their use for financing imports from hard currency areas*: This would be the best means of creating unlimited foreign exchange. If conscription of life and blood for defence is justifiable, conscription for our material advancement is a comparatively mild measure. Two per cent bonds would not be an ungenerous compensation for the conscripted gold and silver. Its success depends on the administrative capacity and moral authority of our Government. The seizure of safe-deposit vaults, freezing of alternative possible stores of value like precious stones, a complete prohibition of loans against or exchange of notes for bullion by banks, abolition of the prohibition of imports in order to lower the value of bullion to a more natural level—these and other ancillary steps will have to be promulgated to ensure the success of the policy. If bullion disappears underground in the process, it will be a desirable end of a potential inflationary threat.

(ix) *Blocking of bank deposits and their gradual release according to the behaviour of the price-index*: The extent of this remedy is limited by the relative unimportance of deposits in our purchasing power—particularly the purchasing power in rural areas. It might give a blow to our banking habit and to less well situated banks. It was tried with success in Belgium—a small country emerging out of the complete dislocation caused by the War and with a highly developed banking habit.

(x) *Withdrawal of 100-rupee notes in exchange for two per cent Government Bonds*: The restraining consideration is the exposure of the character of our people and of the administrative efficiency of our Government and the Reserve Bank which occurred when 1000-rupee notes were demonetized. An offer

of two per cent non-transferable bonds in exchange for the notes on a regressive scale might prove less of a strain on the honesty of our people. The non-transferability could be limited to ten years in the first instance and transfer allowed thereafter only by registration. The measure will have greater chance of success if stocks of precious metals, etc. are first-frozen or, better still, they are nationalized with a deferred payment on a regressive scale after ten years.

xi Stop on wages, salaries and profits: This has very little meaning unless the output expands or prices are brought down by other means. With an inflating price-level, stop on wages and salaries means increase of gross profits; and stop on dividends means either appreciation of investments or increased revenues for Government. Unless the cost of living is brought within the reach of most incomes, a stage is bound to be reached, sooner or later, when the stop will be no longer enforceable.

Controls as a possible Remedy

In our search for remedies for present inflationary conditions we have found no place for re-imposition of controls. The fact is that controls are not a remedy for inflation but only a palliative. A palliative is perhaps unavoidable in the present circumstances; but it would be a grave error to mistake it for a remedy. It is very vital that the distinction should be clearly understood and grasped.

Controls as a palliative for inflation are to a certain extent different from war-time controls. The War, by the obstacles it put in the way of normal supplies and by the demand it made on available stocks, created acute shortages of consumption and other goods. There was of course inflation but the main evil to be dealt with was shortages. Today war as a cause of shortages has ceased to exist and although shortages persist, the main evil to be coped with is inflation.

Controls tend to place a premium on a form of investment which locks up the capital resources of the community and intensifies shortages. In ordinary circumstances, stocks of goods are built up to the level sufficient to ensure an uninterrupted flow of supplies from the producer to the consumer. Controls create a host of parasites between the producer and consumer whose sole object is to hold up supplies till they extract their

price or their premium. If in the ordinary course one quarter of the total goods needed by the community is held in stocks, under controls as much as one half may be found at any time in the possession of these authorized or unauthorized traders. No small part of the trading capital of this country finds its outlet at present into this anti-social activity.

The proper function of controls in times of peace is to prevent costs and wages from racing after prices and thus to offer a temporary respite during which spiralling prices could be checked and lowered to a reasonable level.

Controls cannot hold in check inflation. They merely offer a breathing space during which inflation can be checked and prices brought down in alignment with costs and incomes. If inflation continues, a stage must arrive when controls themselves will be disrupted. The additional purchasing power which inflation brings into play must either remain idle as hoards or have its impact on uncontrolled lines of production. In the latter case, wages will rise in those lines and labour will move away from the control-affected commodities or insist on and obtain a parity of remuneration between the different lines. This is probably what is happening to rural labour which is slowly drifting to the towns. The fall in the produce of land is, therefore, not merely a coincidence of natural forces. It is very likely that land is not attracting labour today in as high a proportion as our backward technique of cultivation requires. It is also significant that in the case of organized factory labour, employment has been falling since 1945 under almost every important head except 'food, drink and tobacco' and the wages of cooks and domestic servants are rising fast. These are the lines in which prices are uncontrolled. If, to remedy the disparities of wage-levels, wages in the controlled lines are brought into alignment with those in the uncontrolled lines, higher wages will soon cause an upward revision of prices and thus frustrate the controls themselves. In short, controlled prices in certain lines cannot be maintained indefinitely, while inflation continues unchecked; and while they last, they create a most serious problem of wage-adjustments in different trades and industries.

It would be prudent to consider whether the steady inflationary trend is not an expression of basic economic facts. When the income of an individual falls he has two alternatives

before him. He can borrow from others or liquidate his investments and maintain his accustomed standard of life. The other alternative would be to revise his standard of life to suit his present income. When the output of a country falls, the situation is not materially different. If the fall is expected to be temporary, it may be defensible to live on loans from abroad or accumulated past investments. In the case of India, these sources hardly exist. The only alternative possible for us, therefore, is a general reduction in the standard of life. The question arises whether our present controls fix our standard of life at the level of our output or whether they fix it above that level and thus aggravate shortages.

Controls—the twin devices of rationing and price-fixation—are an effective means for redistribution of national income. Ordinarily, government taxation and expenditure are employed to achieve this object. But when it is not feasible to transfer incomes in this manner from one class to another, the same object can be achieved by means of controls. Instead of raising small incomes, controls simply bring commodities and services within the reach of these incomes. The ordinary law of Economics is that the producer must not receive in excess of what he contributes to the output. It is possible that controls may operate in such a way that the worker is enabled to consume more than what he produces. Such a rise in standards of life is not to be always deprecated for, in certain circumstances, it may be followed by immediate improvement in efficiency. But except for this likelihood, it would certainly not be prudent for a country to try to live beyond its means in this manner. This is so not merely because one class of workers consumes more than its output and other classes have to forgo their share of the output for their sake. The ultimate outcome of such a situation might well be that other classes will cease to produce as much as they could and thus aggravate shortages and inflationary conditions.

It is probable that we are trying to maintain a level of consumption in food and cloth much above what the country can afford. There appears to be a vague realization of this fact in that exports of cloth of certain varieties are now to be freely allowed. This is nothing but an invitation to consume less cloth and to use the balance for paying for our imports of food. This

food is then to be placed within the reach of the mass of people by subsidizing it out of taxation levied on the more well-to-do classes of people, that is, by curtailing their superfluous consumption or their savings.

Could not the same adjustment take place in a free market for food-grains and cloth? If people on the whole prefer more food and less cloth the prices of food will rise much and the prices of cloth will also rise but to a lower level corresponding to the decreased expenditure on cloth. If stocks of food built out of the subsidy funds were released in a discriminating manner, it should relieve the food situation from time to time. Such a course of action has certain advantages. It leaves to the people themselves the choice whether to have more of food or more of cloth and how much to have of each. It dispenses with controls which have an inhibiting effect on the investment and production mechanism. But a free market in the present conditions presumes that monetary factors are kept under strict check and control and not allowed to play again the havoc of the few months of decontrol the country has enjoyed.

INFLATION

Probable Factors in Recent Price-rise

Prices do not rise unless consumers, including investors, increase their outlay on goods. A strange and therefore suggestive feature of the present situation is that while raw materials and consumption goods have experienced a steep rise of prices, investment values are at a low ebb. An ominous feature of the rise of prices is that the short period from November 1947 to July 1948 has witnessed an upsurge greater than in the preceding two years, 1947 and 1946. It is all the more ominous because during these few months production has on the whole recorded an improvement.

Decontrol of food, cloth, sugar, etc. by itself need not raise prices. It raises prices only when what income-holders were forced to save on account of rationed consumption and fixed prices is now spent on these decontrolled goods. Of how many income receivers in this country, however, could it be said that their expenditure during the controlled era left them with a surplus?

Prices of consumption goods may also rise because people on the whole are inclined to save less and spend more. This might happen in three conceivable ways. Firstly, individuals as such may lose faith in the virtue of saving. There is as yet no direct evidence of this loss of faith, although the recent stability of Post Office savings and cash certificates and of fixed deposits in the commercial banks deserves to be watched. Secondly, what people saved and invested formerly is perhaps being seized now by the Government by way of heavy taxation and disbursed largely on unproductive purposes. Our recent budgets certainly deserve closer scrutiny from this angle. Thirdly, the pattern of income-distribution in the community is perhaps changing in such wise that a large share of the national

income now falls to the lot of the mainly consuming classes. During the War, traders and business classes had their heyday of exploitation. Has the decontrol of agricultural commodities altered the ratio of exchange between agricultural and non-agricultural goods in favour of the consuming peasant? If the flow of new savings is slowly drying up, this fits in well with the fact of the moribund state of investment markets.

Investment disburses Incomes

Every act of investment disburses incomes immediately. But the fruit of investment is delayed for a short time or a long time according to the character of the investment. Damodar Valley may mean a waiting period of 20 years; Konya Valley, perhaps of 10 years; education, of 30 years but health and medicine, perhaps not more than 3 years. In the mean while, disbursal of incomes means inflation, of shorter or longer duration according as we prefer one kind of investment or the other. In the schemes of development and reconstruction at present in hand, which predominate?

Prices sometimes rise because money-incomes of people have risen. Money incomes do not rise unless the volume of money is raised or the volume of bank-credit expands. From November till now, the note circulation has mounted by about Rs. 100 crores and demand deposits by about Rs. 50 crores. Is this rise purely seasonal? Or, is the Government financing itself by ways and means advances first, to be covered by issue of notes later? If the Government is depleting its accumulated balances—they are estimated to have fallen by about Rs. 175 crores over the last two years—the effect is the same as when an individual sells his investment—present savings are consumed. How far have these three factors been at work? Have they been particularly at work during the last six months?

Expansion of money and credit could occur within the monetary system itself. If the market rates of interest are maintained much below the current rate of profit and what the level of savings justifies, a pressure on loanable funds must develop. There is nothing in the world like “discriminating support” to the security market. The prevailing level of market rates is either correct or it is not. Meaningless words are not a good cover for scientific ignorance.

The volume of expenditure could rise because people have begun to throw away money. It could also rise because people have taken into their heads to throw away their past investments and make the best of life while life lasts. Fortunately, except in the case of the uprooted people and refugees, there is as yet no trace of these tendencies. But wise statesmanship should remember that in certain situations people's temper and patience are apt to be short, much shorter than we many times imagine.

International rise, threat to domestic price-level

In certain contexts, rising prices in the outside world mean a threat to the domestic price-level. Contrary to the expectations aroused in last February and March, prices in the U. S. A. have staged a most ominous upward movement during the last few months. Fortunately, their immediate effects on our prices are limited. By severe restrictions on or prohibition of exports, we have prevented our prices of raw cotton, cotton goods, steel, and food-grains from rising to the level of the war-devastated world outside. As the benefit of high export prices are confined only to tea, jute, oilseeds, etc. we have to limit our imports within the range, firstly of the barest essentials, and secondly, of those goods which we are prepared to subsidize, as in the case of food or goods whose prices are essentially non-competitive, as in the case of machinery.

There are two possible dangers in this situation. If such imports do not equal exports, unrequired exports, accumulation of foreign exchange and finally inflation must ensue. Secondly, high-priced machinery may prove as much a burden as high-priced final goods—the products of the former may prove as unsalable as the goods themselves at the prevailing level of domestic prices. Then must ensue an economic deadlock—industrial expansion halts because capital goods are too high-priced, capital goods are too high-priced because prices of their products are kept at a lower level than the world-level, prices of their products are kept low because industrial capacity is not expanding sufficiently! Could both these dangers be met by raising our exchange rate to the highest level compatible with our present volume of exports?
