MONETARY CURE

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The economic system should fulfill its function by enabling mankind to produce the things that it wants and in the quantity it desires. The system must ensure that goods which each of its members produces will be acceptable to others. The proportions to which the economic system works are in a constant state of flux, changing more rapidly or less rapidly from time to time. All is not well with the world. There are maladjustments, unemployment, the extreme swings in the fortunes of people and nations. The economists have from so many decades been exercised to find out a solution for the economic ills the society suffers from. The ills are so many and of diverse character. In order to combat these, some sort of united attack from all nations it necessary, so interlinked is the economic system of the world. This is all the more necessary if the fruits of specialization in the shape of maximum production in humanity's real wealth, are to be shared by all, yet the much sought for international understanding, and co-operation is not forthcoming, nor is there at the moment any substantial possibility of any far-reaching steps in this direction in the near future.

Humanity has time and again suffered from shattering impact of business fluctuations and has been kept constantly thinking in the direction of finding a way out of these economic oscillations. To so many, the working of the monetary system, in its present form, has been the decisive factor in mis-shaping the affairs of men, so that a radical overhaul of world's monetary machinery is a pressing necessity. The basis of continuity of values which a monetary system must provide is lacking in most of the countries. The general price level changes so frequently that contracts made in terms of money have upset the plans of the contracting parties. "Huge adventitious profits and terrible un-merited losses, have been made owing to monetary appreciations and depreciations in the value of the same physical quanta. Prices and costs have failed to keep pace with one and other."

There are gluts or shortages .of capital, causing in turn, stagnation or impeding economic development. Inflation has ceased to be a passing phenomenon. We now hear about the problems of secular inflation. The preservation of proportion in the economic system has always remained elusive, because of the ever-changing nature of consumers' wants and of technology. To maintain complete proportion continuously has been the worry of the economists since Adam Smith. "To be constantly working towards proportion and to preventing drift away from it is a fundamental economic task." To maintain complete proportion continuously has thus far been a very hard task, if not impossible because it has to be carried out in a specialized, growing and ever-changing economic system.

Monetary Equilibrium

Monetary theory is very closely connected with the business cycle theory, since it is impossible to trace monetary movements divorced from the pattern of general economic activity, and also because of the direct dependence of the monetary theory on the general theory of value and distribution.

Foremost among those economists who would advocate an all out monetary programme for the cure of maladjustment is Hawtrey. He is often called a monetary theorist. He believes that monetary control is quite effective to regulate non-monetary causes in business cycles, and that monetary equilibrium is the central factor of economic stability and its absence a fundamental cause of economic depression.

Conditions of Equilibrium in Hawtrey

According to Hawtrey, the business cycle is essentially a departure from monetary equilibrium. The conditions necessary are an equality, between the creation and destruction of money in a given period of time and a stability in the rate of turn-over of money. The transitional period of disequilibrium is caused by the nature of credit system. There is a vicious circle of expansion and contraction, when there are releases and absorptions of cash by consumers when they (consumers or traders) find that their cash balances are not at a desired level. "When credit is expanding consumers' income and outlay are expanding and the release of cash spreads throughout the economy tending to cause prices to rise and economic activity to increase. This process tends finally to increase the desire of individuals to hold cash or absorb cash and eventually equilibrium is restored. On the other hand, a tendency for individuals to hold larger balances — an absorption of cash — will spread throughout the system but will come to an end when a reduction in consumers' income and outlay and in turn-over makes people willing to release cash and equilibrium is restored."[1]

Savings and Investment

Hawtrey is concerned with the maintenance of general demand in order to keep equilibrium but he is also conscious of the savings exceeding investment.

The disequilibrium in the investment market may arise and may act to cause a contraction or an expansion of general demand.

Aggregate savings are the difference between consumers' income and consumption. "An excess of the former over the latter may be represented by (*a*) purchase of instruments of consumption or stock of goods in the hands of consumers, (*b*) investment, or (*c*) changes in cash holdings. Equilibrium means an equality between net amount of investment and the capital raised. If the former is in excess of the latter, then the security prices rise and the Song term rate of interest falls and *vice versa*."

Another part of equilibrium analysis by Hawtrey is the role played by the rate of interest. Equilibrium is attained in terms of a relation between the rate of interest and the rate of profit. He wrote in one of his books, "It is important to observe that whenever the prevailing rate of profit deviates from rate of interest charged on loans the discrepancy between them at once tends to be enlarged. If trade is for the moment stable and the market rate of interest is equal to the profit rate and if we suppose that by any cause the profit rate is slightly increased there will be an increased demand for loans at the existing market rate. But this increased, demand for loans leads to an increase in the aggregate amount of purchasing power, which in turn still further increases the profit rate. This process will increase with ever-accelerated force until the bankers intervene to save their reserves by raising the rate of interest upto and above the now enhanced profit rate. A parallel phenomenon occurs when the profit rate through some chance cause drops below the market rate."

In the field of capital formation he would analyze the investment process and changes in the activity of industry in terms of the relation between the rate of interest and the marginal yield on capital. Equilibrium in the case of working capital is "the achievement by traders of maximum buying convenience." In relation to field capital it means an equality between the rate and the cost-saving capacity of instruments.

Economic activity can be regulated by stabilization of consumers' income and outlay by a control of working capital through changes in the interest rate. This (control of consumer's income and outlay) is essential in Hawtrey's theory of the conditions of monetary equilibrium. "The ideal policy would be to stabilize the consumers' income not keeping it absolutely fixed but adjusting it to the growth of the factors of production in such a way that equilibrium requires the level of wages to remain unchanged. The consumers' income must then expand or contract in conformity with any change in the number of wage earners in the proportion of wages and salaries above the normal wage level, in interest, in rent, and in profits."[2] Consumer's income could be stabilized by the process of "widening" and "deepening" of capital or the regulation of inventories. The short-term rate of interest has a controlling influence over the size of inventories that will be held by the traders. Emphasis is placed on regulation of working capital and the minimization of the possibilities of regulating long-term capital or a control programme through the short-term rate of interest rather than the long-term rate.

The importance which Robertson attaches to the interest rate can be examined by a study of this theory of industrial fluctuations. The theory is like this: "Starting from the equilibrium position in which the actual rate of interest equals the natural rate of interest, the beginning of the boom involves an upward shift of the demand curve so that the creation of new bank money will be necessary to fill up the gap between the rates of lending and savings. But the absolute increase and the larger relative share of the income going to the profit earning class will cause the savings curve to rise to a new point of intersection, indicating a quasi-natural rate of interest which, if equalled by the actual rate, will establish a quasi-natural position of equilibrium. This position is unstable and tends to lead to crisis or a changed rate of lending for the following reasons. First, there may be encroachment of wages on profits leading to a fall in saving curve. Second, the demand curve for new lending may fall to a lower position owing to saturation with existing instruments. The new intersection of demand and supply curves determines a new quasi-equilibrium." "If the actual rate of interest does not fall as low as this level there is an excess in the rate of available savings per atom of time over the rate of industrial borrowings showing itself in a progressive immobilization of savings in the form of bank deposits."

Neutral Money

The cure of neutral money is prescribed by Professor Heyek and other economists of Austerian School. According to them industrial fluctuations can be avoided and full employment achieved if the effective circulation of money can be kept constant. A constant money policy is appropriate in all times whether the effective demand is falling or rising. In the case of falling demand an expansion of consumers' credit will only result in the reduction of productive activity. Expansion of producers' credit will lead to the formation of capital, which is destroyed in financial crisis. There can be no recovery after a crisis by the expansion of credit. "As an economy moves through crisis into a depression the thing which is needed to secure healthy conditions is the most speedy and complete adoption possible of the structure of production to the proportion between the demand for consumers' goods and the demand for producers' goods as determined by voluntary savings and spending." "The only way permanently to mobilize all available resources is therefore not to use artificial stimulants — whether during a crisis or thereafter — but to leave it to time to effect a permanent cure by the slow process of adapting the structure of production to the means available for capital purposes." Heyek would like to confirm the old truth that "we may perhaps prevent a crisis by checking expansion in time but we can do nothing to get out of it, before its natural end."[3]

The structure of production as described in Prices and Production applies to a closed economy in the case of real world. Heyek would consider it necessary to expand or contract the effective money supply of a nation in proportion to the variations of its trade with the rest of the world trade.

Heyek has nevertheless pointed out some limitations of neutral money policy as a norm. He said, "The concept of neutral money was meant, in the first place, to be an instrument of theoretical analysis and not necessarily a tool of practical policy." He is conscious of other influences, besides monetary, on prices, such as long-term contracts in fixed money sums, the rigidity of prices may make such policy impracticable. He is not altogether unmindful of the rigidity in institutional patterns.

Interest Rate and Full Employment

Interest rate is a mechanism through which a relationship is established between financial and real investment. The low rate of interest would stabilize the capital market, by reducing the chances of capital losses, by falling security prices. The capital losses are responsible for shaking the confidence in the market and through this discourage venture investment. A policy of maintaining a low interest rate is advocated by Keynes to stimulate investment for full employment.

Low interest rate is advanced as a remedy for long-term capital deficiencies; low rate interest would promote stability by encouraging capital constructions especially of nature of public, utilities, which are particularly sensitive to changes in capital costs. There is also a strong case for low and stable interest structure to supplement deficient private investment in order to sustain full employment. This will make possible larger scale deficit financing and reduce the cost of public debt. Some economists view zero rate of Interest necessary for loans financed public investments, particularly so, when private investment is deficient and unstable.

The policy of low interest rate is considered to be effective in eliminating the secular trends of savings to out-pace investment in advanced capitalistic economies. ‘A reduction in the rate of interest towards the vanishing point to stimulate new enterprise and investment is a sensible though immediately impracticable proposal.’[4]

In advanced capitalistic countries large savings will be coming forth from full employment even at zero rate of interest. Therefore Keynes considers a falling rate of interest and the euthanasia of the rentier with it as a pre-requisite to a System of private enterprise.[5]

Inadequacies of Monetary Policies

We are in a somewhat unsettled state of monetary policy. There is disagreement on not only policy matters but also on the details of analytical methods. Monetary theory has failed to provide an explanation of the operation of monetary forces which can make possible its governing principles. What constitutes an appropriate monetary policy has become a matter of point of view and of emphasis with different economists. Monetary policy is now being considered as only one of the elements of general economic policy. This seems to be the view of both Keynes and Robertson. Robertson’s writings make it abundantly clear that much faith in the omnipotence of monetary control is futile. The measures should be wider according to him. ‘The real economic evils of society’, he said, ‘— inadequate production and inequitable distribution — lie too deep for any purely monetary ointment, to cure, not even a wise man can turn a world which is unjust and poor into a world which is rich and just. The mending of the road over which the produce passes to market is no substitute for the digging and dunging of the fields themselves. No tinkering with counters will take us very far towards the discovery of an industrial system which shall supply both adequate incentive to those who venture and plan and peace of mind to those who sweat and endure.’[6] Keynes would include in his control programme a considerable participation of the state in controlling the volume of new investment. Hawtrey, of course, seems to have a strong faith in the monetary cure for all situations except in the case of what be calls a credit deadlock.[7] Austerian School economists too have a sort of belief that all that is necessary-is monetary equilibrium or neutral money.

Another weakness of the monetary control programmer is that monetary policy is not related to any particular phase of the cycle in which it is to be applied. It only describes the aim of a long-term policy, not telling what should be done in a particular state of expansion or contraction. Heyek in his Prices and Production, for example, is all the time engaged in his analysis based on the assumption of fully employed resources. Keynes and Hawtrey are principally engaged in the cure for depression, and in the case of Heyek money supply must be kept constant regardless of the state of the employment of resources.

The central position in the control programme of Keynes has shifted over to direct action by the state in the field of public expenditure. He proposes a policy which will increase the propensity to consume and inducement to invest until full employment is reached. A progressive taxation and interest rate lower than the marginal efficiency of capital are the steps towards full employment. A policy of public works expenditure as a supplement to interest rate reduction are the device for the comprehensive socialization of investment.

A prominent flaw in Keynes' programme which is often mentioned by his critics is that 'the difficulty in Keynes' public works programme is that it may have unwanted effect both on the expectations for future yield on capital and on liquidity preference. If the propensity to hoard does tend to strengthen, then Keynes' scheme will head for a more thorough socialization of economic life than he appears to calculate.'

Again, 'Keynes' programme would not indicate the kind of wage and price policy to be followed by the state in its public works programme, and again it does not tell in precisely what manner is the public works programme to be financed. Thus, the programme will not commend itself as a fundamental cure for the basic economic ills of capitalism.

Dominance of Fiscal Policy

The writings of Professor A. H. Hansen and W. H. Beveridge have created a tremendous influence on the efficacy of budgetary methods for the realization of desirable economic goals, (especially the achievement of full employment). Lately, however, the emphasis has progressively been shifted from emergency measures to cure unemployment already in existence to a programme of continued and efficient use of resources to keep up economic equilibrium. Thus the policy seems to be now of compensatory expenditure more related to prices, consumption and income distribution than to mere unemployment.

The achievement of policy goals through expenditure machinery has been tried by many Governments Programmes of expenditures providing automatic changes in these correlated with swings of economic activity in the private economy has been quite popular in United States. Under the Federal and State Unemployment Compensation Legislature, Government would increase the expenditure during depression.

Through public expenditure the following desirable ends may be sought to be achieved:

(*i*) the change in price level,

(*ii*) the desired consumption level,

(*iii*) the desired employment level, and

(*iv*) distributive justice in income.

Government expenditure that gives additional income to consumers is likely to stimulate prices. Such expenditure may take the form of relief payments or bonus payments.

Prices of basic raw materials can be stabilized through purchasing these commodities (like wheat and cotton, for example) when there is a surplus. A minimum wage policy can go far towards stabilizing wage bills, and thus prevent violent fluctuations in business activity.

Investment expenditure in public works like roads, canals and schools will increase consumption indirectly through added employment and this will also stimulate private investment. The Government expenditure can also be designed to promote consumption function. This type of expenditure is again related to the type that is set a foot to achieve full employment (*via*, providing an effective demand for goods and services).

With the tremendous growth of public expenditure during the modern age the curative powers of fiscal methods has increased beyond expectation of those who till lately ware beating the antiquated drums of banking methods. Such domineering is the invasion of budgetary methods in the field of policy, that monetary cures have become out-moded. If not obsolete, its shape has certainly been dwarfed in importance and utility. Yet, there is no denying the fact that monetary policy shall continue still to be a useful supplement of fiscal policy.

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5. Horrod — Towards a Dynamic Economics, pp. 129-150.
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7. A sort of situation which develops when resources available for investment are in excess of capital raised.