Vidyodaya J. Arts, Sci., Lett. Vol. 2. *No.* 1 *pp.* 1-17 *January* 1969.

Monetary-Stabilization Policy in Underdeveloped Economic Systems: A Critique*

by

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IN discussions of the economic problems of underdeveloped countries, it has been widely suggested that, in contrast to the position in developed economic systems with well-established and sophisticated financial markets, institutions and practices, there is in underdeveloped economies little scope for the short-run stabilization of aggregate demand through central-banking action[1]. Thus while the old debate about the efficacy and desirability of monetary policy in developed economic systems continues, it is generally accepted that monetary policy would be much less potent in underdeveloped than in developed economies.

The purpose of this article is not to uncover impressive new layers of statistical evidence, or to attempt a comprehensive theoretical criticism. It is to re-evaluate the consequences of this view and its main pillars. The consequences are shown to be important and the arguments supporting it, obsolete or weak. It is suggested that the conventional thesis requires restatement, quite apart from possibilities offered by the technique of 'advanced deposits' in underdeveloped open systems explored by Olakanpo and others.[2] The gap in *per capita* product between the rich and the poor nations has widened in recent decades. It is implied below that this has paradoxically been accompanied by a significant narrowing of the gap in central-banking potentialities.

The argument of this paper is that (*a*) the potential for monetary management in underdeveloped economic systems is underestimated; (*b*) the potential has increased in underdeveloped countries and (*c*) decreased in developed systems in recent decades; (*d*) the stabilization potential of fiscal policy and of administrative controls relative to monetary policy in underdeveloped systems is exaggerated; (*e*) the gap in counter-cyclical potential of fiscal

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* A paper read at the Ceylon Studies Seminar (Series No. 9) at the University of Ceylon, Peradeniya, on 10-6-69. The writer is much indebted to Professor R. I. Downing for helpful criticism.

1. 'One of the most remarkable features of all discussion of central banking is the unanimity with which all writers regard a developed money market as essential for the effective functioning of a central bank'. S. N. Sen, *Central Banking in Underdeveloped Money Markets*, Bookland Private Ltd., Calcutta, 1967, p. 1.

2. J. O. N. Olakanpo, 'Monetary Management in Dependent Economies', *Economica*, N. S., XXVIII, Nov. 1961, pp. 295-408; J. Marshall, 'Advance Deposits on Imports', I. M. F. *Staff Papers*, VI, 1957-58, pp. 239-257.

policy between developed and underdeveloped systems may be wider than in the case of monetary policy; and (*f*) a good deal more would be done by suitable policies and institutional changes to harness and nurture the existing monetary-stabilization potential in underdeveloped economies.

With regard to (*c*), it is postulated that concomitants of economic growth have steadily been reducing the potency of monetary controls in developed systems. This has resulted from (i) the growth of a massive and widely-held public debt; (ii) the swelling flood of money substitutes, in the form of claims upon financial intermediaries, which has greatly increased the interest-elasticity of the liquidity preference function in the range relevant for monetary policy (iii) the practice of internal (self) financing of investment, and the shortening of business horizons associated with risks and uncertainties;[3] (iv) the volatility and autonomous character of consumers spending on durables[4] and (v) the increased mobility of funds between countries.[5] 'Cost-push' theories of inflation cast further doubts on the ability of central banks to achieve full employment with price stability: we may have rising prices with significant unemployment. (i) to (v) are debatable issues; but they are not debated here.

The interest-elasticity of saving and investment functions—and the strength and persistence of 'asset effects' of interest-rate changes—in underdeveloped systems ought to be, but are not, evaluated because they remain largely unexplored areas. In view of the importance of these matters for policy, it is surprising that no systematic and intensive testing of these relationships has been undertaken. Aggregative time-series statistics—hard to come by in many underdeveloped systems in any case—are likely to be less revealing on these issues than micro-economic survey data. But this writer is unaware of the use in underdeveloped countries of the sophisticated sampling techniques and interview and questionnaire methods now available to the profession for such purposes.

The rest of this article falls into five parts. Part II indicates some consequences of the conventional (impotency) thesis. Part III rejects past experience as a major guide to present and future potential. Part IV criticizes the foundations of the impotency thesis. Part V questions optimism about fiscal policy and administrative controls, relative to monetary policy. Part VI, in conclusion, suggests reformulation of present thinking on the problem.

II. Consequences

The conventional thesis has many practical consequences. It has, for instance, contributed much to the view that the formation of central banks in underdeveloped countries has largely been a matter of fashion or prestige, a symbolic gesture of national dignity, sovereignty or nationalism, devoid of substantial economic significance because 'the scope for policy action is extremely limited' in such surroundings and does not justify on economic grounds

3. Now that we no longer have faith in the 'availability doctrine' of Roosa and others.
4. Of course, some fluctuations in U.S. have been damped by autonomous changes in consumption.
5. Which, on the assumption of a fixed exchange rate may hamper the pursuit of domestic monetary policy. R. A. Mundell, 'Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates', *Canadian Journal of Economics and Political Science*, XXIX, 4, Nov. 1963, pp. 475-485.

'the full panoply of a central bank'.[6] Indeed as late as 1957, Sayers was painting a picture of the central banker, with his 'completely inoperative' rediscount rate, 'published in the hope that someone would sometimes notice what it was' sitting 'in splendid isolation, twiddling his thumbs'[7] and suggesting the addition of some commercial banking functions to rescue him from his enforced but dignified state of unemployment.

This view in turn has strengthened opposition to the establishment of new central banks from economists, politicians and even central bankers.[8] It has helped to prolong the life of currency boards in some countries; and of commercial banks with limited central-banking functions in others. It has given rise to proposals for the replacement of currency boards by a 'small specialized section in a small government department armed with the necessary powers',[9] by a 'monetary institute'[10] or similar intermediate or hybrid devices rather than by central banks.

In some cases, as in Ghana and Nigeria, central banks were formed, but the establishing acts did not arm them with powers much larger than those of currency boards.[11] In the '50s the Bank of England in particular took the view that the new central banks in African countries should be 'as much like the old currency boards as possible.'[12]

These arguments for 'hastening slowly', animated in some instances by active fears that the new central banks, far from contributing to stability, might aggravate inflation,[13] have been stated on a general plane perhaps most ably by W. F. Crick.[14] His case for the 'continuance of currency board arrangements, perhaps modified in the direction of changes noted in the workings of the East African Currency Board' or similar 'evolutionary' institutional improvisation rather than for a fully-fledged central bank, is based on the ground that 'a central bank is an expensive organism in terms of money and manpower'. This argument is too ambiguous. Is a central bank in an underdeveloped economy necessarily as 'costly' in terms of 'money and manpower' as, say, the Bank of England? Further, should the formation of central banks in underdeveloped economies be supported if the costs in terms of money and manpower were 10 or 20 per cent lower? Such questions are more than a futile exercise in arithmetic if only because they bring into sharp relief the fact that economists have no operational economic criteria for deciding at what stage of backwardness a central bank, rather than an enlarged currency board, should be established. The desirability of a central bank is

6. W. F. Crick (ed.) *Commonwealth Banking*, Clarendon Press, Oxford, 1965, p. 12.
7. R. S. Sayers, *Central Banking after Bagehot*, Clarendon Press, Oxford, 1957, pp. 112-13.
8. 'Most central bankers themselves appear to be opposed to the establishment of central banks in many of these newly independent territories, ostensibly on the ground that such institutions can play no useful part', E. Nevin, *Capital Funds in Underdeveloped Economics*, Macmillan & Co., London, 1963, p. 22.
9. Crick, *op. cit.*, p. 14.
10. J. B. Loynes, *Report on the Future of the Currencies of Sierra Leone and Gambia*; Government Printer, Sierra Leone, 1961.
11. They have subsequently enlarged their powers very considerably.
12. C. V. Brown 'Effective Monetary Controls in Developing Countries. The African Experience', *The Banker's Magazine*, Sept., 1968, p. 149.
13. Especially if run by unexperienced personnel, J. L. Fisher, *Report on the Desirability and Practicability of Establishing a Central Bank in Nigeria for Promoting the Economic Development of the Country*, Nigeria, Government Printer, 1952.
14. Crick, *op. cit.*, pp. 13-17.

not positively related to the degree of economic development. Indeed, Friedman has argued for the abolition of the Federal Reserve system in the existing form in the long run, and replacement by a 100 per cent reserve deposit system, in the world's most advanced economy.[15]

The new central bankers, most of whom had assimilated the impotency thesis as undergraduates, who have worked from the outset in a climate of assumed futility of monetary policy and who have suffered doubts about the efficacy of particular instruments of control for the purposes for which they were transplanted from developed economies, have understandably been reluctant to deploy monetary policy swiftly, firmly and to the fullest possible extent. These attitudes have tended to stifle experimentation and inventiveness which might have been expected to emerge in situations uncluttered by tradition and precedent. Further, to the extent that the impotency thesis derives support from 'experience', past failures to use central-banking tools boldly tend to reaffirm scepticism about the future usefulness of central banks. It is not surprising that the resurgence of monetary policy from the '50s onwards as a major government weapon in the treatment of inflation and cyclical instability in advanced economies was not accompanied by a parallel rediscovery of money in the underdeveloped countries, in spite of the linkages between the two worlds.

Because of the assumed ineffectiveness of monetary policy, it has also been urged in turn that in underdeveloped economies (*a*) central banks should be content with performing modest but useful 'ancillary functions'[16] without attempting discretionary management for the present; (*b*) their main objective should be to develop money markets and other 'machinery for monetary control',[17] modelled presumably on developed systems; (*c*) as a pre-condition to monetary management, central banks should aim at 'a high stage of economic development' with a 'broad-based economic structure'[18] or simply that their main goal should be to assist the process of economic growth and capital formation. Some limited stabilizing possibilities are conceded, but these are assumed to arise mainly from central-bank influences on fiscal policy. That is to say the impotency thesis has implications also for the choice of central-banking techniques; but these are not further explored.

Finally, because of the acceptance of the conventional view and the post-Keynesian scepticism about the effectiveness of monetary policy compared with fiscal policy as an instrument of stabilization in advanced economies, it is customarily assumed without adequate empirical evidence that fiscal policy is correspondingly more effective than monetary policy in underdeveloped countries. Pessimism about monetary policy, even if firmly founded, does not justify optimism about fiscal policy. Nor should judgements of fiscal policy in developed systems be imported unquestioned into underdeveloped systems. Part V questions the basis of such optimism.

III. The past as a guide to future potential

Appraisals of past performance of central banks in underdeveloped countries will not yield large new insights into present and future potential. They can at best be only marginally useful.

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15. Milton Friedman, 'Comments on Monetary Policy', *Rev. of Eco. and Stat.*, XXXIII, No. 1, Feb., 1951, pp. 186-91.
16-17. R. S. Sayers, *Modern Banking*, Clarendon Press, Oxford, 3rd ed. p. 290.
18. H. A. de S. Gunasekera, *From Dependent Currency to Central Banking in Ceylon*, George Bell & Sons Ltd., London, 1962, p. 302.

Available evidence is weak. Observed behaviour for most underdeveloped systems is brief indeed. Even the history of the older central banks are distorted by two wars and the great depression; apart from changes in policy goals and in the institutional setting in which goals must be pursued. Any specific weapons can be judged in only a few historical situations. These become fewer still if it is accepted that a new central bank needs a minimum of 20 years merely to find its feet.[19] In any case, future developments may well fall outside the narrow range of observed experience.

The effects of discretionary monetary policy must be separated out from interwoven effects of 'built-in' stabilizers; and from the effects of other policy instruments being used in pursuit of identical or conflicting goals. Statistical deficiencies preclude the use in many countries of econometric models for isolating fiscal or monetary factors. Apart from the limited number of observation years—most series run out after a few years—and high intercorrelation among the series that might be used, many series are too unreliable. Even from a theoretical standpoint, it is not enough to show that experience is not incompatible with the impotency thesis; it is also necessary to show that other hypotheses are incompatible with the same data. We must allow for the possibility that apparent impotency may merely reflect failure to abandon some policy goals in situations where the goals outnumber policy instruments; and for the possibility that aggregative statistics may cloak significant effects in particular markets or sectors, and fail to delineate impact effects and short-run and long-run effects of policy instruments.

In so far as past failures are the result of errors in analysis and prediction, performance may improve with better flows of information, with experience and with advances in analytical and forecasting techniques. To the extent that they arise from faulty conception or unskilled execution, the future could be more optimistic. If they stem from inadequate legal powers of central banks, the search for new weapons may bring forth new powers. If they are traceable to special factors or historical accidents or to some major institutional or policy adjustment,[20] these may not recur or persist. It is only where institutional or structural properties of underdevelopment have limited the areas of direct or indirect impact of monetary policy, where such impediments continue, and cannot be overcome by ingenuity that we can expect past evidence to strengthen the impotency thesis.

Considering the relatively slender empirical base that underpins the massive output of discussion on monetary issues even in developed economies,[21] it is not surprising that essays in the evaluation of past monetary measures have turned out in retrospect to be little more than exercises in personal judgement. The fashionable search for material *supporting* the impotency thesis is unlikely to end in balanced appraisals or to uncover rich veins of

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19. R. S. Sayers, *Banking in the British Commonwealth*, Clarendon Press, Oxford, 1952 p. XV.
20. Such as the attainment of political independence and subsequent realignments of constituent groups.
21. Which no doubt evoked the survey comment that 'there is probably no field of economics in which the writings of economists are so strongly influenced by both current fashion in opinion and current problems of economic policy as the field of monetary policy', H. G. Johnson, 'Monetary Theory and Policy', *Am. Econ. Rev.*, LII, June, 1962, pp. 336-384. The revival of belief in the potency of monetary controls in the U.S. rose partly from disillusionment with the practical feasibility of using fiscal policy. Milton Friedman, 'The Role of Monetary Policy', *Am. Econ. Rev.* Vol. LVIII, March, 1968, pp. 1-17.

untapped possibilities. The impotency thesis represents not an impregnable empirical fact, but a doctrinaire posture based on a repetition of inadequately-tested ideas which impedes the quest for workable solutions for which there may be no exact formula or precedent in the history of developed economies.

IV. Foundations

The conventional view stands on a few main pillars.

It is usual to argue that underdeveloped economic systems are characterized by large 'subsistence sectors'. Within the subsistence sector, by definition,[22] attainable monetary-policy effects must be near zero. A further dichotomy is alleged to prevail within the 'money economy', where the 'unorganized sector'—whose links with the 'organized sector' are few and far between—is beyond the reach of monetary authorities. To make matters worse, the organized sector of the money economy is said to be 'compartmentalized' to a high degree. Since commercial banks serve only one or two of these compartments, it is affirmed that central banks could expect at best to influence only a narrow segment of the money market by controlling commercial banks.

A subsistance sector will certainly reduce, to that extent, the sensitivity of the economy to monetary stimuli, whether they are provided by central bank or by fiscal policy. But the argument is a double-edged one. A subsistence sector will also weaken the need for stabilization because it is insulated from inflationary or deflationary movements. The argument depends also on the magnitude of subsistence and unorganized sectors, individually and in combination, relative to the economy as a whole. These differ widely among underdeveloped nations. For instance, the non-monetized sector is usually assumed to comprise one-tenth of the Ceylon economy and one-third, of the Indian, while the unorganized sector is assumed to cover, in addition, 50 per cent of the money economy in both.

Neither the subsistence nor the unorganized sector is ever homogeneous. Subsistence practices interlace with barter ingredients and money transactions in varying degrees. Some peasants work for a money wage part of the time on a casual, seasonal or regular basis in agriculture, or rural manufacture. Others work as traders, brokers, commission agents, domestic servants, dancers or musicians. Ceylon's subsistence sector is impregnated with monetary elements—because of the pervasive aura of plantations—to a greater degree than India's. Some operators in the unorganized sector have one foot in the organized market and vice versa. India's organized sector with its far more dominant role of the professional 'money lender', and its specialized castes and sub-castes of indigenous bankers,[23] is probably more organized than Ceylon's unorganized sector.

In most countries monetization—the secular erosion of the subsistence sector—has proceeded apace so that the subsistence-sector argument has much less force today than, say in the '40s and '50s although this is usually slurred over in the literature. Though reliable evidence is not available, the

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22. Subsistence sector is usually defined as the non-monetary sector.

23. There are four well-known castes in India: *Brahmana*, *Kshatriya*, *Vaishya* and *Sudra* castes who have specialized in banking. The famous *Nattukottai Chettiar* bankers whose operations expanded into several neighbouring countries before the '30s are a sub-caste of the *Chetti* caste which is a segment of the *Vaishya* caste.

countries which have experienced the fastest secular contraction of the subsistence sector are not necessarily those that saw the swiftest rate of shrinkage of the unorganized sector of the money economy. Nor is there much reason to expect that the countries with the most rapid growth of *per capita* or aggregate output will be those with the highest rates of diminution in the subsistence or unorganized sectors, although there is probably a loose-knit two-way causal relationship. The links between the organized and the unorganized sectors have also not expanded consistently with economic growth. Both in Ceylon and Burma, the links were largely severed with the withdrawal of *Chettiar*[24] bankers to India after the heavy losses incurred in the 1930s Depression[25] and were not substantially replaced until the '50s and '60s.

Apart from any increases in *per capita* income achieved in recent decades and the fillip that this may have given to monetization, there has been a phenomenal growth of indigenous banking in many countries,[26] and a proliferation of other financial institutions.[27] A decade ago these changes provoked the comment that 'few underdeveloped countries lack credit institutions; some of them already have too many'.[28] New links have been established between different segments of the organized sector, between organized and unorganized sectors of the money economy, and between the money economy and the subsistence economy. This process has automatically enlarged the potential role of monetary policy. The integration of financial structures is of course, by no means complete. But where the basic institutional components exist and are capable of further rapid expansion, a cohesive framework of financial interrelations is quickly attainable.

The alleged problem at the heart of the 'compartmentalization' argument is not one of increased complexity and variance in modes of behaviour among component segments in a multi-cell system which must be comprehended and regulated by the central bank with a few policy instruments. The charge is rather that partitions inhibit the radiation beyond its own boundaries of any spark kindled exogenously by the central bank in any one segment. (A preliminary objection is that this may work both ways—any inflationary impulse originating in any one segment will lack propagative power—but the benefits of intergration may outweigh this consideration). The problem is one of segmentation of mobility and substitutability. There are two methods of assailing the segmentation problem that could be merged into one composite strategy.

One method is to perforate the insulating walls with an institutional web which can communicate to all parts of the structure the impulses imparted by the central bank at the hub of the system—a process proceeding apace in many underdeveloped countries, but which could develop new directions.[29] The other is for the central bank itself to gain a foothold at selected critical

24. See footnote 23 above.
25. *Report of the Ceylon Banking Commission*, Ceylon Government Sessional Paper XXII—1934; U Tun Wai, *Burma's Currency and Credit*, Orient Longmans Ltd. Calcutta, 1953.
26. Ceylon, India, Pakistan, Malaya, Nigeria, etc.
27. Co-operatives (Ceylon has 14,000 co-operatives and India 235,000) savings banks, rural banks, agricultural, industrial and development banks, insurance agencies etc.
28. B. Higgins, *Economic Development*, W. W. Norton & Co., N.Y., 1959, p. 483.
29. For example, banks could engage in 'pawn-broking' and co-operatives in consumer loans etc.

points in each compartment. With the first method, reaction to central bank stimuli will depend on (*a*) the speed and the extent of the transmission, and (*b*) the behaviour modes of the economic units concerned. With the second method (*c*) largely ceases to be a problem, and more scope is provided for tailoring the stimuli to the behaviour patterns of particular classes. Both methods increase the sensitivity and responsiveness of the system to instruments of control; but the second method does so without simultaneously intensifying sensitivity to other exogenous shocks, such as export price changes. The transmission of central bank impulses by the first method alone may also be too slow and uncertain.

The unconventional second method calls for ingenuity, but is attainable through many routes—e.g. by empowering central banks to control non-bank operators in particular compartments; by selective controls aimed at carefully chosen segments; by open market operations in a wide array of assets as well as in government bonds; by enabling a whole new range of borrowers and assets to qualify for discounts, rediscounts, and central-bank advances of varying maturities; by directives and announcements; by the purchase of shares, debentures, and other liabilities of co-operatives, mortgage banks, etc; and by the offer of assurances, guarantees, participation, rewards, subsidies, personnel, training facilities, etc. For instance, if the core of central-bank impotency is the shape and the behaviour of the aggregate supply function, the central-bank must attack the institutional determinants of that function, perhaps through its advisory role to the government and its immense moral authority with financial, business and labour groups. The absence of central-bank traditions, depicted as an obstacle, and the fact that many institutions are still in their formative stages may be an aid to the use of new methods.

Such a new possibility is to link up the 'money lender' with co-operatives, banks and indeed with appropriate devices with the central bank itself, instead of the present policy of planning his extinction. The emergence, with central-bank guidance of an expanded, competitive and virile money-lending profession, with access to credit and title insurance, centralized lender-of-last resort arrangements and pooling facilities is certain to lower the cost of credit to the unorganized sector; to augment 'intermesh' effects; and to release an army of bureaucrats now engaged in the impossible task of propping up a network of inefficient 'co-operative' credit agencies. With flexible lending practices, money lenders possess greater powers of penetration into the crevices of unorganized and subsistence sectors. Economists have rendered a disservice to agrarian reform by overstressing the cupidity of money lenders and by ignoring their efficiency potential. Are they really more unethical than other business groups? May they not form the seedbed of a future entrepreneurial class?

Both in the literature and in practice, the emphasis continues to be implicitly on a linear conception of history; and explicitly on the imitation of market structures of present-day advanced economies rather than on adaptation of inherited components. Central banks in underdeveloped countries have not yet scratched the surface of the potential scope for (*a*) developing consultative and financial relationships with traditional operators such as indigenous bankers, money lenders, pawnbrokers, money changers, rotating credit associations, commercial-bill discounters, commission agents, retail traders, etc. or (*b*) the patterning of financial structures along existing socio-economic configurations of familial, kinship and religious affiliations.

The 'subsistence-sector', 'unorganized-sector' and 'segmentation' arguments, like the distinction between 'developed' and 'underdeveloped' money markets[30] which has parallel implications for monetary policy, are heroic oversimplifications. No one quarrels with simplifications that yield new insights. Designed as aids to analysis, these categories have congealed in the literature, as crystallized substitutes for the more specific characterization of market structures. All economic systems and sectors have similarities and dissimilarities. From the view-point of further analytical usefulness, these arguments overstress differences between underdeveloped and developed economic systems; and understress differences between underdeveloped countries and within segments and markets. More serious, the differences which are sharply silhoutted are not suggestive and helpful in forming new policies. The single oppressive image of the subsistence sector as a homogeneous but shapeless inchoate mass is especially limiting in the search for solutions.

The second pillar of the conventional view is built on the assumed reaction of (dominating) expatriate banks. It is said that they will remain inert and insensitive to central-bank stimuli because (*a*) they command large deposit resources of wealthy expatriate enterprises with limited local credit needs; (*b*) they pursue ultra-conservative lending policies; and (*c*) they can borrow funds at will from head offices overseas, from sister offices or from other foreign sources through their extensive connections. Because of (*a*) and (*b*), they are saddled with perennial excess reserves. Together with (*c*), this implies likely non-adherence to conventional liquidity ratios. Further, the local expatriate bank is simply one link in a massive chain of branch offices stretching across many countries. Local portfolio decisions are made not on the basis of the bank's local position, but predominantly on the head-office view of the total picture. Optimal spatial distribution of total bank assets from the bank's point of view may conflict sharply with local national interest. Central bank control over the banking system is said to be negligible.

This is an apt image of the banking scene up to the early '50s, and some of its ingredients no doubt survive in some countries.[31] By and large, however, it has changed radically.[32] First, expatriate banking behaviour has changed significantly. Bankers' attitudes to indigenous borrowers and sensitivity to local events have changed in the transformed socio-economic *millieu* which followed the diffusion of political independence. More specific causes were competition by indigenous and some foreign—American, French, Japanese, Indian and Pakistani—banks; greater dependence on local central banks and heightened sensitivity to local liquidity ratios (with lessened liquidity and inability to borrow funds from abroad at will because of central-bank and government curbs); the changing composition of bank personnel (with more

30. See footnote 1. This dichromic division of world's money markets obscures, within each category, many differences and variations significant for monetary policy. Further the 'developed', and 'underdeveloped' markets of today are very different from those of the '40s and '50s.

31. Even in the old set up, central banks can still make some effective use of fractional reserve ratios, especially if (*c*) is nullified by local asset ratios, exchange control provisions, etc. (*b*) may be an aid to stabilization during the boom though an impediment in the slump. The final argument may spell an advantage in that it reduces induced banking expansion and contraction, but an embarrassment in that it may imply intrusion of unpredictable autonomous elements.

32. For instance, expatriate banks in Ceylon now have lower liquidity ratios than indigenous banks.

Asians and Africans); the growing power and prestige of local central banks and the tendency of expatriate banks to look to them for protection against nationalistic 'excesses'; geographical extension of bank offices (in some cases) and some limited expansion of bank lending for activities outside foreign trade. Secondly, although expatriate banks continue to be giants in total size relative to indigenous banks, their relative position within many countries has diminished at an increasing rate. Thirdly, while the rapid relative growth of non-bank financial intermediaries has sapped away the potency of monetary controls in advanced countries, in many underdeveloped economies the banking system has grown impressively in relation to the total credit system. While expatriate and indigenous banks have shared in this forward thrust, the relative significance of expatriate banking has declined steeply in many cases. Thus even if we ignore the changed behaviour of expatriate banks, including their new dependence on central banks, the growth of indigenous banking has greatly increased the degree of dependence of the banking system as a whole on lender-of-last resort functions of the central bank.

Moreover, this dramatic new banking expansion has been spearheaded in many countries by state (or state-associated) banks rather than by private enterprise; and this has brought a new dimension to monetary policy. In controlling state banks, the central bank may find its conventional armoury superfluous or ineffective. Indeed, the degree of potential control of the banking system as a whole now within the reach of many central banks because of the growth of state banking is probably unprecedented in developed economic systems. Further, because of the growing number of linkages, the non-bank credit structure is in many cases, in contrast to the position in developed economies, becoming increasingly dependent on the banking system. In some instances where central banks have shown ingenuity, linkages between the central bank itself and non-bank credit institutions have also increased. Frequently, non-bank financial institutions are themselves wholly or partly state-owned.[33] That is to say, the latent power of central banks to control non-bank financial institutions is probably already much greater in several underdeveloped countries; and in others the process is under way.

It was argued above that links and contacts with the rest of the economy are capable of considerable short-range extension if central banks revise their views and attitudes towards traditional operators and institutions and towards conventional techniques such as open-market operations and central-bank advances and discounts.

Three other arguments customarily buttress the impotency thesis: (*a*) the narrowness of the bond market which rules out large-scale open market operations; (*b*) the absence of a bank-rate tradition which renders the manipulation of the bank rate futile; and (*c*) the small size of private investment relative to aggregate expenditure (and to export receipts) which renders changes in investment unimportant in the determination of aggregate demand.

Even these arguments are not unassailable. The narrowness of the bond market need not prevent a central bank from developing open market operations in assets other than government bonds. Even if these other markets are equally narrow, the effects of open market operations in a series of narrow markets may well add up to more than those attainable in a wide bond market.

33. For instance, life insurance in India and all insurance in Ceylon are nationalised.

In any case in a narrow market, a central bank can achieve a given change in the bond rate with smaller open market operations than in a wide market. In underdeveloped bond markets, speculative elements are virtually non-existent,[34] so that relatively large (or small) rate changes could be achieved without triggering off speculative surges. The proportion of the national debt held by small savers and households is negligible in such systems, and need not be a major constraint on bringing about relatively large changes in the bond rate. Central banks in many underdeveloped systems possess the statutory power to issue their own securities,[35] and need never run short of the exact type of bonds they need for their selling operations. Discerning observers have already glimpsed in specific markets a larger potential than is commonly attributed to open market operations.[36] Further, in dependent systems the 'perverse' cyclical behaviour of liquidity and interest rates is such that even the maintenance of constant rates or 'orderly conditions in the market' would permit substantial open market sales during the boom and purchases during the slump. The literature underestimates the need for 'defensive action' by central banks and the scope for the use of open-market operations in defensive action, and dwells almost exclusively on 'dynamic action' in underdeveloped countries. Finally, success in monetary policy in such systems need not depend on open market operations.[37]

Even in the advanced economies, the usefulness of the bank rate as a stimulant during the slump is probably negligible. In underdeveloped systems, central banks may be unable to produce 'expectational effects' through the bank rate at present; but they could no doubt achieve similar damping effects by reinforcing bank-rate increases with warnings, statements and pronouncements. As for market effects (as opposed to psychological effects), a more or less fixed relation has already been established in many countries between discount rates, commercial-bank rates and other rates in the organized sector. Moreover many central banks have ample statutory powers to prescribe maximum rates for banks, with or without bank-rate changes. For a central bank seeking new uses for the bank rate, a whole range of latent possibilities await exploitation; and the absence of a bank-rate 'tradition' could mean freedom from constraint and for innovation. Central Banks can extend credit and rediscount facilities to new categories of borrowers, against a wide range of collateral, for a variety of prescribed purposes. They can discount many types of paper perhaps with higher rates against less acceptable paper. Rates can be varied according to purpose, according to borrower, according to paper or collateral. A whole schedule of rates can be published and cyclically varied. Eligibility requirements can be changed anti-cyclically. Rates could be linked to the amount or duration of loans. Ceilings can be imposed on borrowings from the central bank; or the latter could warn banks that access will be denied if they do not follow prescribed policies, etc.

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34. The proportion of bonds that change hands in the market is usually negligible because bonds in underdeveloped systems are usually in the hands of firm holders.

35. For example, Ceylon, Philippines, U.A.R., Honduras, Mexico, Paraguay, El Salvador, Chile, etc. Others could be given this power.

36. For example, R. C. Porter, 'Narrow Security Markets and Monetary Policy: Lessons from Pakistan', *Economic Development and Cultural Change*, XIX, No. 1, Oct., 1965, pp. 48-60.

37. Many countries already substitute other techniques for open market operations. They range from variable reserve ratios and minimum liquidity ratios, which may include government bonds as permissible liquid assets, to detailed administrative instructions to banks.

With regard to (c) above, the potential for monetary policy depends not only on the relative size of investment, but also on the degree of potential control over investment and on associated multiplier effects. Even if possible compensatory changes are ignored, the mere prevention of induced changes is no insignificant contribution. Orthodox central banking will be tempted to combat inflation by damping down *ex ante* investment to match *ex ante* saving. Concern for growth suggests that this may be ill-advised; and that central banks should aim at cuts in consumption rather than in planned investment. Consumption is also by far the quantitatively more significant variable. In rich countries, externally financed consumption consists mostly of spending on durables. For other items, the consumer is his own banker. In poor countries, a very considerable proportion of day-to-day consumption, conspicuous consumption and 'ceremonial' expenditure depends on credit availability and therefore qualifies for monetary restraints.

The source of such credit is the unorganized lender, not credit institutions. Monetary policy must aim at curbing consumption more than investment. This is an added reason for (*a*) coaxing traditional operators such as money lenders into the orbit of central-bank influence, and (*b*) developing some consumer credit through institutional sources, in place of the present (presumably growth-orientated) policy of discouraging credit institutions from consumer loans (and non-institutional lenders from all loans).

Several generations of economists have succeeded in isolating the conditions that make for successful monetary policy in the specific institutional setting of advanced capitalism. Unable to locate identical conditions in underdeveloped economic systems, they have concluded in consequence that monetary policy must be impotent unless the surroundings were changed. They have prescribed the achievement of a superstructure of 'developed money markets' over the underdeveloped base as the sole remedy. (They further assume implicitly that the allocation of real resources for building such superstructures —also referred to as 'the institution-building role' of central banks or as building 'the financial infra-structure of economic development'—will, by a happy coincidence, necessarily be more beneficial for economic growth than alternative investments). But suppose that we follow the reverse order and modify our view of how central banks must behave. Suppose that we (*a*) formulate new central banking weapons and strategies suited to the problem, and (*b*) create conditions that will make weapons and strategies useful in themselves and for monetary policy. In many instances the latter can be a rapid process that does not require our waiting for the distant day when a high degree of economic development has already been reached. Scattered evidence from many different underdeveloped sources provide glimpses of a considerable, existing and developing potential capable of quick amplification in skilled hands.

In a fundamental sense, there are only two basic requirements for central banks to be able to influence aggregate demand. The economy should be monetized (if not there is no need for monetary policy), and investors and consumers should finance their activities to a significant degree from credit. Both are amply satisfied in underdeveloped countries. The rest is largely a matter of forecasting and prediction; of ability, skill and manoeuvre; and of ideology, equity and allocative efficiency. We are in effect saying that the potential for monetary policy, defined here as a central bank's ability to influence aggregate demand, in underdeveloped economic systems depends very much on the ability of central banks to organize themselves deliberately for

central banking. The fact that they are latecomers is an advantage to be exploited; and the fact of a different setting is a challenge to ingenuity. They are not causes for despair or for abandoning stabilization in favour of other objectives. Admittedly, some calculated groping in the dark framework of inherited institutional arrangements may be unavoidable.

V. Fiscal policy (and administrative controls)

In any democracy, regardless of *per capita* income, probably no state agency can insulate itself completely from group pressures exercised through the political machinery. But fiscal policy is less sheltered from political cross currents and sectional or regional pulls than monetary policy to an extent dependent on the degree of independence of central banks from treasury control. Fiscal policy is also less flexible; less capable of moving by steps and stages; and less easily reversed or modified. It can rarely be used for offsetting concrete day-to-day or month-to-month disturbances. Time lags between the recognition of the need for stabilising action and policy formulation, and between policy formulation and implementation are also greater in fiscal policy, again without reference to *per capita* income. These important differences, sharply etched for developed economies, are submerged by the debris of other matters in discussions of underdevelopment.

The capacity of underdeveloped countries to moderate cyclical swings via taxation appears to be exceedingly limited. The limiting factors are basically the stark reality of low *per capita* income; and attendant symptoms of underdevelopment such as subsistence and barter elements. The high concentration of people in the lowest income categories means that the vast mass of population is exempted from income tax. The circle of exemption is widened by the dilution of a given income among a larger number of recipients resulting from 'work-sharing' (under-employment) arrangements associated with 'extended-family' concepts. It is frequently overlooked that subsistence sector limits fiscal policy just as much as monetary policy. Even in advanced countries the inclusion of home-produced goods and services in taxable income has not been satisfactorily solved. Taxes in kind (e.g. food grains from farmers, labour services on local capital projects, etc.) have been suggested but have not generally become important.

The corporate form of business organization is little developed in underdeveloped countries. Many households are also 'firms' to a great extent.[38] The bulk of aggregate income originates in agriculture. The assessment of agricultural income on millions of tiny, fragmented, labour-intensive, primitive farms and other small-scale rural activities dependent on vagaries of weather, and subject to many forms of exploitation by traders, landlords, priests and money lenders, pose formidable problems, quite apart from the high costs of assessment and collection. They become doubly difficult when the income earner combines other occasional, seasonal or part-time activities such as trading and handicraft production with his main occupation in partnership with other members of the extended family; when no systematic books or accounts are maintained, or businesses maintain more than one set of accounts; when tax returns are not filled in because of illiteracy; when the social *millieu* does not demand voluntary compliance with tax laws and may

38. For example, 80 per cent of India's work force is self-employed.

indeed tolerate, if not openly encourage, evasion and avoidance,[39] and when the tax administration itself may be lacking in the skills, competence and integrity which are taken for granted in developed economies.[40]

One of the practical problems of taxing away additions to income in the upward phase of the cycle (or with economic growth) is to locate the increases as they are generated. But the flow of information in underdeveloped countries is not usually adequate for such purposes. Variations in tax rates may also be ruled out for other reasons. They may not be practical politics in situations of instability. Income increases may be considered necessary on humanitarian grounds; to improve health and stamina; or to induce future sacrifices. It may be feared that higher tax rates, by reducing supplies more than demand through adverse effects on incentives to work and bear risk, may prove inflationary rather than disinflationary; or will retard long-run capital formation by encouraging capital flight, discouraging foreign investors or depressing domestic private investment. It could of course be argued that the latter effect could be offset by increases in government investment. But the civil service may lack levels of competence for such an enlarged role. Moreover, the erosion of investment incentives may weaken savings propensities. Rate adjustment may also be impossible because income increases are occurring in areas where, as part of a deliberate policy of fostering economic growth, income-tax concessions or exemptions have been made.[41]

The income-tax base is usually much smaller in underdeveloped than in developed countries because income exempt from tax is higher relative to *per capita* income. The basic level of taxation on companies is also lower. The establishment of a reasonable base for an excess profits tax is more difficult because of factors such as inadequate accounting and statistical records. It is hardly surprising that direct taxation accounts for a smaller proportion of government revenue. When much of the total product originate in agriculture, land taxes are seemingly attractive and have in fact been widely used. But land-tax revenues have proved in practice to be inelastic,[42] because of the basic difficulties already specified; because of low levels of agricultural income in relation to exemption levels; or because of the hostility of politically-vocal large land-owning groups.

Even indirect taxes cannot seep down to the lower strata of a subsistence economy. But they can extend their incidence further down the income scale than direct taxation. We can expect consumers in underdeveloped systems to react to low *per capita* income by allocating a larger proportion of income to consumption; and of total consumer expenditure to 'necessaries' such as food-grains and textiles, characterized by relatively high income elasticities and low price elasticities of demand. The taxing of consumer goods seems an easy way out of budgetary straits, particularly of imported goods which mean that (*a*) they can be collected easily and cheaply at ports of entry, and (*b*) domestic

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39. Frequently a heritage from colonialism when payment of taxes was virtually an act of collaboration with the alien ruler.

40. Central bankers are far more sophisticated and comparable to their counterparts in advanced countries than tax administrators.

41. A 3-5 year tax holiday for particular new industries is a common feature of most underdeveloped countries such as Ceylon, India, Burma, Pakistan, U.A.R., Sudan, Jordan, etc.

42. Heavy reliance on indirect taxes is partly attributable to inelasticity of land revenues.

producer groups are not offended. But the counter-cyclical possibilities of indirect taxes in underdeveloped systems should not be exaggerated. They are generally regressive and provoke political resistence. They may affect health, stamina and incentives. By contributing to price increases in wage goods they may cause labour unrest and work stoppages which may aggravate inflationary pressures. Indirect taxes on 'non-essentials' and 'luxuries' are not regressive but may not be feasible if they are important to governing *elites*. When feasible they may yield little revenue because of high price elasticities of demand, or because consumption has already shrunk to minor proportions, or because they are apt to depress work incentives. Finally, many underdeveloped countries are committed to indirect-tax exemptions, usually for 5-10 year periods, especially for imported capital goods and raw materials, and for handicraft products.[43]

Export duties would seem an attractive counter-cyclical device in dependent systems and have in fact been so used to some effect by several countries.[44] When they are *ad valorem* they may exert significant 'built-in' stabilizing effects. But counter-cyclical variations in tax rates may not be feasible for many reasons. Upward revisions are difficult in an upward phase because many such export prices are believed to be subject to steep secular decline; or because of expectations of repercussions on the inflow (or outflow) of foreign capital, particularly where the export industries are foreign-owned. The scope for reflationary action (whether fiscal or monetary) may be cramped by foreign-exchange shortages. The use of export taxes may also be limited by fears of encouraging the search for substitutes or the loss of market to other sellers,[45] or the transfer of resources from export to home production.

Receipts from indirect taxes can be expected to lag behind increases in income and prices while rising prices and costs raise the level of government monetary expenditure and so generate deficit budgets during the upward phase (and conversely in the slump). It is not merely that tax revenue forms a smaller proportion of national income than in advanced countries.[46] The contribution of indirect taxes to total tax revenue is also much greater. The considerable 'built-in' stabilizing effects of the progressive income tax structures of developed economies are not found in the low-income countries, or only in attenuated form. In the fight against inflation, they must lean more on built-in or induced changes in the level of government expenditure. But government disbursements on unemployment benefits, which can be expected to behave in a counter cyclical way, are of negligible quantitative significance in most underdeveloped countries. This is mostly because few poor countries pay unemployment benefits. Involuntary unemployment is more a secular than a cyclical phenomenon. In dependent systems, it is partly because cyclical fluctuations are more in real and money income than in employment.

Counter-cyclical changes in government expenditure can no doubt be achieved to some extent by having in reserve a large file of plans for new enterprises and for accelerating (or decelerating) projects under way. Such

43. Even if it frequently means discrimination against more efficient mechanized production.

44. For example, Ceylon, Malaya, Indonesia.

45. Where taxes are expected to result in higher prices.

46. The ratio of tax revenue to national income in, say, India is about 9 per cent compared to 25-30 per cent common in developed countries.

possibilities are however, limited by well-known technological and engineering constraints. In most underdeveloped countries, fiscal expansion is ruled out by exchange shortages and by bottlenecks in skilled labour, tools, machinery and raw materials.[47]

Cyclicaly-unemplloyed workers may be geographically immobile or highly specialized in exports so that they cannot be quickly diverted to home production; or home production may already be characterized by extensive 'disguised unemployment'.[48] The pressing need for building up social overheads, administrative services, defence forces and, above all, the capital stock, the urgency of creating new jobs and for meeting, at least in a modest measure, the growing clamour for a variety of social relief and welfare services generated partly by demographic pressures and partly by the escalation of consumer expectations, commitments to consumer subsidies on a number of items on the one hand and to guaranteed-price schemes for encouraginghomeproduction on the other hand introduce important (downward) rigidities into fiscal expenditure.

In countries where recent economic growth has been particularly slow or where (colonial) political power had been used to build up narrow entrenched groups, low-income groups are exerting strong pressures for a redistribution of income through fiscal policy. Analytical and forecasting difficulties add more to the risks of using fiscal policy as a stabilization device because of greater irreversibility than to monetary policy. Unsatisfactory accounting records and proceedures and the ineffectiveness of financial controls over disbursements make the manipulation of government expenditure difficult and unwieldly. In other words, the adaptability of budgetary processes to the requirements of short-run stabilization is much less in the underdeveloped countries, partly because of their greater domination by other objectives and pressures and partly because of concomitant properties of underdevelopment. While the potential power of monetary policy has increased in recent decades in underdeveloped economic systems, many of the major constraints on fiscal policy, notably the downward rigidity of government expenditure associated with demographic pressures and popular aspirations have grown in significance.

With counter-cyclical possibilities of fiscal policy weak, the tendency in underdeveloped countries has been not to give greater weight to monetary policy, but rather to rely increasingly on administrative controls. They are not used for the purpose of facilitating the greater use of domestic monetary policies. Their appeal is largely based on their alleged greater certainty of impact and on the belief that they could be more detailed, and therefore be applied with more selectivity. They are prohibitively expensive in terms of limited bureaucratic resources. Their alleged scope for selective and discerning use is belied by poor administrative resources; by failures to delegate authority; by antiquated regulations and proceedures and by ponderous precedents. The many millions of small, often illiterate producers, distributors and consumers and poor transport and communication facilities impose overwhelming difficulties.

47. These are also constraints on expansionary monetary policy.

48. These are also constraints on expansionary monetary policy.

Once introduced controls are politically difficult to dismantle if they are ineffective or no longer necessary. They breed black markets and corruption. More than monetary policy, they tend to reduce the usefulness of the price mechanism for decentralized decision making, with all the consequences that this entails. It is not merely that when fiscal policy fails, undue weight is initially assigned to direct controls. When direct controls also fail, the tendency is not to allot more work to monetary policy, but rather to multiply direct controls and to prescribe more penalties for evasion, in pursuit of desired results. Far from inducing mobility and flexibility, physical controls tend to choke enterprise and initiative. The resulting rigidities may be particularly damaging in periods when major structural changes in the economy are desired.

VI. Conclusion

The domestic incomes of underdeveloped economic systems are thought to be basically stable[49] in the sense that they are devoid of any strong, endogenous cyclical pattern. But an oscillatory exogenous force of periodic and powerful character is imposed upon many underdeveloped economies by fluctuating external demand for their exports. It was not the aim of this article to contend that such exogenous shocks have diminished in the degree of their violence or in the rhythm and frequency of their occurrence, that central banks now possess greater power to modify the primary impact of such shocks, or that other (non-export) income determinants have now become relatively more important. These possibilities were not investigated. Our argument has been that the sensitivity and responsiveness of domestic aggregate demand to central-bank stimuli have increased[50] and could be further strengthened relatively quickly. (Whether the sensitivity of the domestic economy to external shocks has also increased was not explored). This may also mean that the range of tolerance for mistakes in monetary management has decreased.

If the impotency thesis *has* to be retained, although in attenuated form, a restatement possibly in terms of other impediments, with explicit recognition of the absence of invariance, appears to be overdue. Such a reformulation it was shown, however, will carry very different policy implications.

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49. Apart possibly from climatic factors such as 'rainfall cycles'. The likelihood of oscillatory movements arising endogenously in the absence of external shocks deserves further exploration.

50. Supporting arguments did not include advantages accruing to monetary policy from succession of able governors, the highly trained personnel that central banks now possess, habits of consultation and co-operation already established with financial and business worlds, etc.