Deficit-Financing, Inflationary Pressures
And Economic Development

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Economists believed till the Great Depression and the publication of Keynes's General Theory that credit creation, though justifiable for the private sector, was actually harmful if resorted to for financing public sector expenditure.

Inflationary pressures were considered inevitable during a development process; however, the same process was expected to generate forces which would check and correct these pressures.

Keynes challenged both these beliefs; he justified credit creation for the public sector and showed how the economic mechanism was not self-regulatory.

Since then and particularly after the Second World War, there have been two schools of thought. One believes that credit creation for the public sector or deficit-financing is justifiable only within certain well-defined limits and that inflationary pressures retard the development process.

The second believes there is nothing wrong in principle in credit creation for the public sector and that moderate inflationary pressures are likely to promote rather than retard the development process.

It is proposed to discuss these two views in this article from the stand point of underdeveloped economies.

The classical and the neo-classical economists held the view that credit creation for the purposes of the State would harm the development process. This view was based on the distrust of the governments. Governments, it was believed, were generally irresponsible with regard to their expenditures and further their expenditures, too, were, by and large, of an unproductive (in the classical sense) character. There must be, therefore, some limit to their expenditures. This limit was put by the resources which they could obtain from the public by way of taxes and borrowing. Thus arose the Gladstonian doctrine of balanced budgets.

The private sector shared this view; in fact the economists rationalised the views of the business class. The business class did not want the State to do what could be done by the business class. This class further did not like the State to draw away resources from the private sector for financing unproductive expenditures. It was necessary therefore to limit the expenditure of the State. The doctrine of balanced budget provided the effective well defined mechanical limit to State expenditure. It was believed that the State would be irresponsible in its expenditure if it was left to its discretion; the doctrine of balanced budget provided a way of not permitting the State to use its discretion.

Credit creation for the private sector, however, was considered both necessary and desirable as the private sector was supposed to undertake expenditures of a productive character. Schumpeter's view that credit creation was the monetary complement of the innovation process, was not perfectly understood; however, nothing was said against the credit creation by the banks for financing private sector expenditures.

Again Schumpeter's view that development process was cyclical under the then circumstances did not find wide acceptance; however, inflationary pressures and depressions were considered quite normal and self-correcting phenomena.

Governments were, by and large, not to undertake anything that could be left to the private sector and even its interference with a view to regulating the development process was considered to be undesirable.

KEYNES AND THE NEW DOCTRINE

The Great Depression came as a rude shock to the orthodox economists. Keynes rationalised the depression experience and showed that the economic mechanism was not likely to be self-regulatory. He justified deficit-financing (that is credit creation for the public sector) with a view to bringing about full employment. He in fact went further and held that since the private individuals were not likely to take investment decisions from the point of view of the long-term interest of the economy, the State should take upon itself the task of making investment decisions.

Keynes thus shook the orthodox belief in laissez-faire and in the undesirability of deficit-financing. In place of the rule of thumb based on the distrust of the State, Keynes maintained that the role of the State as well as deficit-financing had to be judged from a functional point of view.

PROBLEM OF THE UNDERDEVELOPED ECONOMIES

Further, during the post-war period, the problem of the underdeveloped economies became prominent. It was widely realised that the State had inevitably to play an active role in the development of the underdeveloped economies and even for that reason, some deficit-financing was inevitable.

Here again the economists rationalised the views of the business class. This class in the underdeveloped economies realised that without an active role of the State in the development process the private sector would not be able to flourish. For the success of the private sector, the business class wanted the State to undertake development tasks in certain fields. This class realised that if the State did not provide the momentum to the development process, the private sector would not be able to do much.
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Because of Keynes and the problems that has arisen in the post-war period, the orthodox view has been modified. The neo-orthodox economists recognise the importance of the role of the State in regulating as well as promoting development and the role of deficit-financing. The distrust of the State still continues and therefore attempt is made to put again arbitrary well defined limits to the role of the State as well as deficit-financing. For the purposes of the present article, the discussion would relate only to the role of deficit-financing and inflationary pressures.

NON-INFLATIONARY DEFICIT FINANCING

The orthodox economists opposed deficit-financing but had no views regarding inflationary pressures, which they considered as more or less inevitable during a development process. The neo-orthodox economists under the pressure of circumstances, have recognised the role of deficit-financing; however, they hold that the magnitude of deficit-financing should be limited to the non-inflationary level. Inflationary pressures would bring about a mal-allocation of resources and thus retard the pace of development; deficit-financing, therefore, must not create inflationary pressures.

The neo-orthodox economists, however, are not satisfied merely with saying this. Their distrust of the State is as strong as that of the orthodox economists and hence they do not want to leave the question of deciding the non-inflationary level of deficit-financing to the State. They have to find out a mechanical rule which should guide the State in its policy regarding deficit-financing.

Their mechanical formula is this: money supply should grow at the same rate at which real income grows and the magnitude of deficit-financing necessary to bring about this increase in money supply is non-inflationary. Of course, they do allow for the increase in money supply necessary for increasing monetisation of the economy as well as for a more than proportionate increase—in relation to the increase in real income—in the precautionary cash balances. Any way, here is a formula and the State should adhere to it; otherwise, there would be inflationary pressures.

KEYNESIANS’ APPROACH

Economists who do not agree with the neo-orthodox view are called, for the purposes of this article, Keynesians. Their objection to the neo-orthodox view is two-fold. (a) They hold that it is not possible to estimate accurately the magnitude of non-inflationary deficit financing by the mechanical formula devised by the neo-orthodox economists. (b) They further hold that inflationary pressures, within limits, would not only not retard development but actually accelerate its pace.

The formula, the Keynesians maintain, will give the magnitude of non-inflationary deficit-financing only if the pattern of demand is consistent with the pattern of output. If these two patterns are not consistent with each other, then the deficit-financing determined by the formula would lead to either inflationary or deflationary pressures. For example, if food, the basic consumption item in an under-developed economy, did not grow at the required rate, the so-called non-inflationary level of deficit financing would lead to inflationary pressures; for the general price level would certainly rise with the increase in the price of an important commodity like food and this price-rise would be further aggravated by the induced increases in wages and costs. Similarly, if the wage-goods output increased at more than the required rate, the so-called non-inflationary level of deficit-financing would lead to deflationary pressures. Prices of key commodities like food would determine the general price level; the magnitude of non-inflationary deficit financing therefore should be determined not by the formula suggested but in the light of the demand and the output pattern of key commodities. Ex ante, therefore, it is not possible to determine the magnitude of non-inflationary deficit-financing; it can be determined only by a process of trial and error in the light of the developing situation. The State then has to use its discretion in this matter and its policies should not be tied down to mechanical formulae.

The neo-orthodox economists maintain that investment should be limited to the available and potential resources. They further hold that by creating inflationary pressures, available resources cannot be increased; on the contrary there would be mal-allocation of available resources and hence the rate of growth would be smaller with inflationary pressures than without them. The Keynesians do not agree with this proposition. Their contention is: how can anybody know the extent of available resources? If all the available and potential resources were known, maximum possible investment in a given situation could be determined. However, the fact is that the actual magnitude of available and potential resources is not known in advance and can be known only during a development process. There are several latent resources and latent possibilities of input-combinations which can be known and exploited only when an economy is passing through stresses and strains of the development process. Entrepreneurial ability and managerial talent, whether in the private or the public sector, have full play only when some pressures are created in the economy: then there is a compelling necessity to find out the latent resources—both human and material—and the latent input combinations. It is a matter of common experience that man realises his latent capacities only under crisis-situations. Similarly an economy would realise its growth-potentialities only under crisis-situations. It is a matter of history that innovations have taken place only because of the pressures, challenges and disequilibria generated during the process of development.

The development process is unbalanced in this sense; for, development takes place largely because of the imbalances generated during the process. In fact it can be said that the pace of development of an economy would depend upon the intensity of imbalances that are created during a development process. These imbalances, of course, would accelerate the process of development only if (a) the general socio-economic climate is development-oriented and (b) the intensity of imbalances is not so great as to break the economy.

Inflationary pressures, thus, the Keynesians maintain, have a role to perform; they help an economy in realising its full growth potential. Of course these pressures should not be so great as to create explosive and un-controllable situations. Thus the development policy, according to the Keynesians, does not consist in applying mechanical formulae; it is an art. Any economy with a strong
With great skill, interlacing threads of many colours, the weaver transfers the master design to the cloth... symbolising, as it were, our many-sided efforts to redesign the fabric of the nation's life.

In this national effort, rubber products are playing an integral part. Tyres, latex foam cushioning and industrial rubber products manufactured by Dunlop, for instance, are helping to transport men and materials, move mountains of earth, build dams and factories, and bring comfort and elegance into the home.

-DUNLOP
and effective government well versed in the art of development policy could realise a higher rate of growth than an economy with a strong government equipped with mechanical formulae. With a weak government, especially in an underdeveloped economy, development becomes a matter of chance.

CONCLUDING REMARKS
The Keynesians are probably much too sharp against the neo-orthodox economists’ formula regarding non-inflationary deficit-financing. The neo-orthodox economists probably use formulae only to indicate in very broad terms the magnitude of non-inflationary deficit-financing under certain assumptions; they, in practice, would change this magnitude in the light of the pattern of demand and of output. Further the governments, as they are constituted, are likely, to be irresponsible in their expenditure policy if they are not provided with some unambiguous simple formula. Thus the approach of the neo-orthodox economists to the problem of non-inflationary deficit-financing would, in practice, turn out to be better than that of the Keynesians.

The basic difference between the Keynesians and the neo-orthodox economists is with regard to their respective attitude towards the desirability of inflationary pressures. In this matter, too, the difference between the two regarding policy prescriptions is not likely to be substantial. When the governments in the underdeveloped economies are having ambitious plans, there is probably merit in suggesting to them that they should avoid inflationary pressures or take action to correct them. In practice, the intensity of pressures required for development would be generated and still the emphasis of policy would be towards correcting them.

The Keynesians, too, probably would advocate similar policies under the circumstances.

Still, for an underdeveloped economy trying to formulate a plan for development, it would be probably in its interest to rely more on the Keynesians than on the neo-orthodox economists. During the implementation stage, after some pressures are already generated, it would be in its interest to pay some attention to the views of the neo-orthodox economists. However, at no stage, it should allow its policies to be moulded completely by the neo-orthodox economists; for, they are just ignorant of the dynamics of development.

Credit Control in Evolution

Sukumar Chakrabarti

Bank advances have, not been properly integrated into the structure of planning.

Priorities on which planning is based have no meaning to a hanker. To him a firm of cosmetic makers may have as much, if not more, claim for credit than a firm producing fertilisers of which we are in dire need.

It is doubtful whether banks will be able to retain for long their present liberty of choosing their borrowers with little concern for the priorities laid down by the Planning Commission.

The technique of credit control can be developed more purposefully if control is directed towards channelising bank advances into uses necessary for planning.

‘THE presence of a sizeable non-monotised sector and the strategic position which food supply occupies in the Indian economy make it difficult to establish a close causal relationship between money supply and prices. In the current situation, the problem of prices is not simply monetary, but covers production as well as consumption. This makes the Reserve Bank’s task of fighting inflationary forces more difficult and takes the edge off its instruments of control. Quantitative control on credit with its inhibiting effect on production and employment cannot be favoured under present circumstances, when efforts have to be made to raise both production and employment. Its effectiveness in holding the price line is also doubtful in any case.

The Reserve Bank, therefore, rightly directed its policy of credit control in 1956 on those spots where speculative forces had gathered to create inflationary pressures. Speculative hoarding of foodgrains was partly responsible for the food price index rising more rapidly than the general index. The Reserve Bank, therefore directed banks to reduce their advances against foodgrains and raise the margins against such advances. The selective credit control policy was further sharpened by discrimination between advances made in producing and consuming areas.

FROM SELECTIVE TO AGGREGATIVE CONTROL

But the effect of the directive was disappointing. Hoarding of foodgrains was not financed primarily by bank advances and such of it as was, the Reserve Bank could control. It could not prevent bank funds from percolating into the foodgrains trade through clean advances and other means. The Reserve Bank soon realised that it was difficult to insulate any particular sector or Sector against an over-all rise in bank credit. Seepage of funds from the non-restricted to the restricted sector frustrated the policy of selective credit control.

In 1958, therefore, the Reserve Bank, introduced quantitative control through persuasion or exhortation to support its selective credit control policy. Banks were directed to reduce their level of advances by Rs 80 crores during the slack season, but no attempt was made to restrict credit expansion during the busy season. Market forces were, thus, allowed to determine the level of advances during the busy season while the Reserve Bank controlled them in the slack season. This introduced an element of uncertainty into the situation and uncertainty breeds speculation and to that extent, this technique of control, it may be argued, added to the speculative forces in the economy.