MULA

WAR FINANCE
WITH SPECIAL REFERENCE TO MALAYSIA

by

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A Graduation Exercise presented to
the University of Malaya in
part fulfilment towards the
Degree of Bachelor of Arts
with Honours in Economics

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The writer wishes to record his gratitude to Dr. Lim Cheng Yah for his valuable comments.

CHAPTER I

INTRODUCTION

Nobody likes war and if it is thought of, it is always associated with the accompanying tragic events and devastating consequences. Few, if any, (except for some individuals and those connected with the Treasury), ever think of how a war is financed. War Finance is a branch of government finance and it is the art of raising the required funds to finance a war. The government of a belligerent country calls for help from the financial system to mobilise the country's resources to meet the war. However the necessary mobilisation could not be done by finance alone; other measures of control are introduced. In War Finance therefore, finance could not be studied alone or exclusively ; the economic controls adopted by government have to be studied along.

Government in every country has to perform important functions. For these it requires funds. Under peaceful conditions such funds are acquired by taxation. The remaining gap in its budget is covered by borrowing, both temporary and permanent. Its temporary borrowings will be mainly from banks while permanent borrowings are from the savings of the community and foreign borrowings. For some countries like Brunei another source of fund is income from property. The greater part of the activities of the country are carried on by the services of paid employees voluntarily recruited and with commodities bought in the market. The situation changes with the outbreak of war and government is forced to introduce physical controls as distinct from measures operating via the price mechanism. To understand better as to why such a change is inevitable, it is necessary to have a rough idea of the characteristics of a war economy.

With the outbreak of war, expenditures of government are greatly increased. In the United States during the four war years 1942-45, Federal government spent approximately 310 billion dollars, 280 of which was for war purposes.[1] Mobilisation expenses must be met; the navy and the air force must be strenghtened; payrolls increase as more men are put under arms; guns, munitions, etc. must be obtained swiftly. The government has to be provided with increasing funds to make the programme a success; patriotic

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[1] Rollin G. Thomas - Our Modern Banking and Monetary System (Prentice-Hall), p.569.

~~attempts~~ appeals and monetary rewards are either too slow or not strong enough to make it effective and as such the introduction of economic controls is found to be necessary. The insatiable needs of the military sector are obvious as long as the war has not been won and government will try to attempt, with the help of physical controls, to raise to the utmost the production of goods and services at the expense of normal civilian production and consumption. Initially unused resources can be employed but after their exhaustion, production for military purposes can only be increased by a reduction of the production for the civilian sector. There is thus a lower level of consumption available to the latter. To limit the demand of the civilian sector on the goods and services needed for military purposes, it adopts conscription and direction of labour, controls materials at source, issues licences, and limits the money supply available to civilians by taxes and forced savings.

In a free exchange economy, the mobilization of resources to war effort has to be paid for. A government will try therefore to raise as much money as possible by various means possible. The issuing of paper money has often been done in the past but a prudent government knows its limit and the difficulty of maintaining its value. Taxation is another way by which government can raise its revenue but experience has shown that it cannot meet the heavy budgetary demands of total warfare. Furthermore there is a limit to taxation for after a certain level, the taxpayer is likely to lose interest in improving his economic position further. Taxes therefore can be heavy but not to the extent the government would destroy the productive effort of the population. Any remaining government deficit may be financed by borrowing from the public, from banks and from external sources. Each of these sources has its own advantages and shortcomings but it is sufficient here to say that the different sources of borrowing to be made depend on the size of the war expenditure and the duration of the conflict.

Up to now, no reference has been made to underdeveloped countries which are found for the most part in Afro-Asia. Here the situation is quite different because they are not industrialized to any considerable extent and many of these countries depend largely on their primary products for their governments' revenue. Taxation and banking systems are for most places rudimentary and the amount of income left for saving among the people is small. This means that in the event of a great and prolonged war, these countries have to rely more on borrowing externally and on foreign aids. A chapter will be devoted to the situation in Malaysia, a typical developing country of Asia.

In this article, War Finance will be discussed with reference to the mobilisation of resources for war effort, the raising of enough funds to finance the war, the means to meet inflation and capital flight, the measures to limit and protect civilian needs and the equitable distribution of burden in war. Chapter two will deal with the problems of War Finance. The most obvious is to acquire the necessary funds but this is not the end of the picture. A more serious problem which will become a post-war burden is that of inflation. The next chapter will portray the various measures that can be adopted by Government to meet the problems. The Western world had experienced the financing of large scale wars in the two World Wars. Chapter four will give a short description of their experiences. A short appraisal will be made in the concluding chapter.

With respect to equitable burden of war, it should be exercised only whenever possible. The overriding objective in war is to win it and it is claimed that everyone has to sacrifice as much as possible. Taxing the rich only will not bring forth a sufficiently large revenue and it is therefore necessary to tax the poor as well. It will be seen later that despite the heavy taxation, the poor can still be relieved from bearing an ever-excessive burden. The benefits got from winning a war are not restricted to a few but to all the citizens of the country and as such the question of burden must be subordinated to that of victory.

CHAPTER II

PROBLEMS OF WAR FINANCE

As Mc Ivor writes, the basic economic problems which confront a country in time of war include (1) producing the goods and services for carrying on the war, (2) paying for these goods and services used for war purposes, and (3) supplying the everyday needs of the civilian population. While it is the second of these problems that wartime finance is immediately concerned, it is the first which is fundamental and to which others must always be subordinated.[1] The government has to be provided with command over as large a proportion of the resources of the community as possible to meet the war and there is never any limit to the insatiable demands of war. The mobilisation of resources for the war effort involves the transfer of a large proportion of the adult population away from its peacetime occupations into the armed forces, into the munition factories and even into export and home industries where new labour is needed to replace the young people withdrawn for more active war service. Transfer of other resources - of factory and warehouse space, of land from agricultural use into airfields and other military uso, and from one agricultural use to another more appropriate to war conditions - has also to be effected on a huge scale. In the past, the sequence of economic phenomena when war broke out remained relatively simple; government expanded its armed forces, speeded up production in its own ordnance factories and dockyards and for the rest of its military requirements went into the open market as purchaser. However the financial tradition of the past cannot retain its relevance in a war of twentieth century.

In meeting the central task of a war economy, the government calls for help from the financial system not only in promoting the transfer of resources from one use to another and in raising to the utmost the productivity of the mobilised resources, but also to ensure that goods and services needed from abroad can be bought. Financial policy, however, is only one of the instruments that may be used to bring about the necessary distribution of manpower, materials and equipment. It must be studied along with other methods of economic control which will be discussed in the

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[1] R. Craig Mc Ivor - Canadian Monetary Banking and Fiscal Development (The Macmillan Co. of Canada Limited), p.165.

next chapter. The government of a country can force its people to work without payment but 'compulsion is limited in scope and moreover services compulsorily rendered and goods compulsorily requisitioned have to be paid for.'[2] The objective of an adequate programme of war finance are to provide funds for financing the enormous wartime expenditures, to restrict the civilian demand for resources in order that these may be made available as needed for war purposes, and to allocate the economic burden of thr war as equitably as possible. In attempting to meet this objective, problems are created and it is such problems that must now be discussed.

The main problem of war finance arise from the fact that money can be used not only as an instrument to divert resources to war purposes, but also as a means to divert resources to the satisfaction of the heterogeneous private purposes that remain an obstacle to the achievement of total war. Before war, the whole necessary transfer of resources can be accomplished through the intermediary of money, e.g. people entered into these occupations because they were attracted by monetary inducements. However during war monetary rewards and patriotic appeal are not strong enough to achieve the necessary transfer, and this necessitates the employment of other economic controls by government.

The central problem during a war is the coming into existence of an inflationary gap between the swelling supplies of purchasing power distributed unequally among the people of a nation and the diminishing supplies of purchasable goods available to the nation. The government is confronted with the problem of finding adequate revenue and the aspect of confining expenditure. Wherever possible economy in consumption and civil investment goods should be practised. A proper balance must be struck between the direct war effort - the strength of the Services and war production - and the civilian economy; and also between production for internal use and for export, taking into account the goods and services that can be secured by importation. Keynes said that we can start out either by fixing the standard of life of the civilian and discover what is left over for the services department and for export; or by adding up the demands of the latter and discover what is left over for the civilians. The actual result will be a compromise between the two methods.[3] Any attempt to maintain civilian production at levels higher than are necessary to provide the essential fo health, efficiency and morale implies a corresponding limit to the size of the armed forces

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[2] R. G. Hawtrey - Currency and Credit (Longmans, Green and Co.), p.183.

[3] J. M. Keynes - How To Pay For The War (Macmillan & Co. Ltd.), p.4.

and to war production. To quote Keynes once more, in peacetime, the size of the cake depends on the amount of work done. But in wartime the size of the cake is fixed. If we work harder, we can fight better. But we must not consume more.[4] To meet the problem of raising revenue, government introduces and raises taxes, issues paper money, expands credit, and seeks loan from the public and monetary institutions, and external loans. In doing so it creates an inflationary situation - inflation of prices and the depreciation of currency leading up to a complete instability of the unit of value.

No democratic country at war can avoid inflation. The initial impetus can come from the upward rise of costs reflecting disorganisation. War naturally involves destruction of materials and productive property thereby creating artificial scarcity which accounts for the existence of a war boom. To maintain a steady pull on resources the government has to offer higher wages and prices. The higher taxes on commodities resulted in higher prices. As the nation pay packet is swollen, people attempt to spend more on goods and services so adding further to the total market demand for goods and services already strained by the rising government demands. Thus there is a sort of a tug of war, with civilian production pulling against the services and war production combined. Then as prices rise, employees seek protection against the rising cost of living by demanding increased wages and salaries. This cumulative process is known as the inflationary spiral. Under war conditions, wages tend to be forced up in three ways: there is intense competition for labour for war industries; high prices and profits enable employers to pay high wages; and a high cost of living provokes demand for increases to maintain real wages unimpaired.

The disadvantages of inflation during wartime are well known. A.C. Pigou distinguishes three types of inflation: deficit-induced inflation, wage-induced inflation and galloping inflation.[5] Inflation creates social problem, inflated profits lead to complains of profiteering, it causes industrial strife by the struggle of wage-earners to maintain their share of the market, distorts price structure and encourages a wrong distribution of resources and falling value of money. People lose the incentive to save and while taking advantage of price changes divert their efforts from useful channels. While the real income of the vast majority is reduced, that of a considerable number is enlarged in some instances to an extraordinary extent. These undeserved and temporary gains tempt many to extravagance in consumption, aggravating the

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[4] J.M.Keynes, op. cit., p.4.

[5] See A.C.Pigou - The Veil of Money (Macmillan & Co. Ltd.), p.133.

inflationary situation. Public life is corrupted, morality becomes a rare commodity and controls lead to black marketing. The latter is bound to occur extensively in underdeveloped countries where the Civil Service is weak.

With a long drawn war which calls for a greater part of the nation's economy, shortage of labour is inevitable. Experience in the two world wars has shown that labour shortage persisted throughout the war despite the employment of women. Under such situation it is natural that wages will rise, though less rapidly than prices. There is therefore a decline in real wages and a relative decline in labour's economic position. New problems in labour relations arise, such as the training of inexperienced workers, urban congestion and inadequate housing, absenteeism and a high incidence of sickness and nervous exhaustion.

One of the ways to increase its revenue is the imposition of new taxes and the raising of existing ones. The government should consider to economise not only in the cost of administering these new taxes but also in spending its revenue. It should see that the taxes do not discourage exports and do not represent a heavy burden to the people. The incidence of taxation has to be properly distributed between the rich and the poor to prevent social problems.

Another way of financing a war is by issuing paper money but its limitations are due to its direct effect on prices. The amount of paper money which must be issued is so great that it depreciates rapidly and soon becomes worthless. Its depreciation results in lower prices for exports and higher prices for imports. In Asia, one effect of an inflationary increase in money supply is to stimulate imports because the low per capita income results in a high propensity to consume.[6] In short an inflationary increase in money supply distorts the economy, weakens confidence in the currency, reduces the incentives to savings and to productive investment, creates difficulties in balance of payments and inflicts hardships on large sections of the community.

Usually when war is inevitable, both foreign and private enterprises fearing the total collapse of the nation transfer their resources abroad. The government has to act to prevent such capital flight which will prove disastrous to the nation, especially one which depends so much on foreign capital in its exporting enterprises.

The next step is to seek public loans. Adam Smith

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[6] Frederic Benham in The Colombo Plan and other essays - Deficit Finance in Asia (Oxford University Press), p.32.

was no lover of public borrowing; but he knew that there was no escape from it 'in moment of immediate danger.'[7] In seeking public loans, the government has to consider the rate of interest as well as the date of maturity of the bonds issued. If short-term bonds are issued the government might not be in a position to repay when they mature. The important point is to get lenders to hold their securities as long as they can be induced to accept. The feeding of government bonds to banks and other institutional investors must take full account of their conventional preferences for certain proportions of short-dated paper. The rate of interest should be fixed as low as possible.

Even after all these attempts at raising its revenue are made, the government is still fased with a gap to meet its mounting expenditure. It solves such problem by resorting to external debt. It has to be paid by exporting more than what is imported or by running debts for the future. The former implies competition with war production and maintenance of essential supplies and services at home, creating another problem by imposing a burden on production. External debt is inevitable for underdeveloped countries in financing a war since incomes are low and the margin for saving is low and as such internal debts bring in only a small amount. If victory can be achieved without resorting to external debts, then they should not be incurred as they create a heavier burden to the community than internal debts.

Having seen the problems of war finance - in short, the raising of enough funds to finance the enormous wartime expenditures, inflation, restricting the civilian demand for resources in order that they may be made available, as needed, for war purposes, capital flight and allocating the economic burden of the war as equitably as possible - the next step is to examine those measures to meet the problems of War Finance.

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[7] Adam Smith - The Wealth of Nations (edited by Cannan), Vol.II, p.395.

CHAPTER III

MEASURES TO MEET PROBLEMS OF WAR FINANCE

The previous chapter has shown that the problems of War Finance are to mobilise resources - materials and human beings - to war effort; to provide funds for financing the enormous wartime expenditures; to prevent inflation and capital flight; to restrict civilian demand for resources in order that they may be made available, as needed, for war purposes; and to allocate the economic burden of the war as equitably as possible. To meet these problems, Government has to adopt various measures and controls and as such war inevitably brings an element of totalitarianism into the economic system.

With the mobilisation of resources, there is no possibility that finance alone could do the work that have to be done. So long as the government's expenditure is on a peacetime scale, the whole necessary transfer of resources can be accomplished through the intermediary of money. But wars cannot be run on the same basis. The work has to be reinforced by measures of direct economic control. The government can take to itself, by defence regulation, specific powers to requisition stocks of goods and materials, to pay manufacturers on the basis of cost and a fair profit, to license dealers, to enforce priorities of distribution and in other ways to establish control over trade. Thousands of plants that normally make peacetime goods can participate in war production and those producing many goods for civilian use, e.g. automobile, referigerators and radios can be stopped. Labour too has to be mobilised and it can proceed to do this by compulsion, conscription, direction of labour, rationing and by allocation schemes of all kinds. As Keynes writes, output can be increased by absorbing those unemployed, by bringing into employment boys, women and retired persons and by more intensive work and overtime.[1] In all the warring countries it has been found necessary to utilize the labour of women to an unprecedented extent. However the factors of production must be employed in such a manner to satisfy at the same time both the expanded military demand and also the civilian demand, though preference is often given to the former. Care must be observed to ensure that military demands do not engulf supplies essential for maintaining civilian efficiency and that among civilians themselves, these supplies are distributed equitably and efficiently. Hancock and Gowing write that on the evidence

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[1] J.M.Keynes, op. cit., p.14.

available, it would seem that Germany's economic failure was not in the special province of war production, but in the allocation of economic resources amongst all claimants, including the civilian population.[2]

To procure funds to finance a war, the government can issue paper money, introduce and increase taxes, borrow from the public and banks, and borrow externally. Since the amount needed is so great, the issuance of paper money has often resulted in inflation making it a main problem to maintain the value of the issued money. Except as an extreme measure of last resort, paper money has therefore come to occupy a subordinate position in war finance. The accepted policy, one the effectiveness of which has been tested by much experience, is to issue paper money sparingly and to secure the bulk of the funds required for war by means of loans. In theory the whole cost of a war can be raised in taxation but in practice this cannot be done. It would involve taking away about half, on the average, of every citizens income and it would cause monstrous injustices between one taxpayer and another. A conscientious government in wartime pushes its collection of taxes as far as it thinks it can but it is never far enough to cover anything like the whole of its expenditure. Taxes on incomes and on some articles entering into general consumption can be imposed. With regards to time, they should be collected monthly or quarterly to prevent unsatisfactory consequences on fiscal grounds if they are paid annually. The advantages of taxes over paper money or the borrowing policy are many. A country which finance itself entirely (apart from foreign loans) by means of income taxes, supplemented by taxes on a few commodities, would experience little or no advance in general prices. Furthermore there is no danger of class antagonism as taxation places all citizens upon an equal footing in so far as war conditions permit. Borrowing from the public would not cause an advance in price level if subscribers made payment entirely either with accumulated funds or with savings made from current income during the period that the proceeds of each successive loans were being expended. However the funds raised are not enough to abridge the budgetary gap and as such government borrows from banks resulting in expansion in the volume of credit in the form of bank notes and deposits causing general advance in prices. As a temporary measure however borrowing is a good policy especially during the initial stages of a war when much funds are needed. Keynes includes in funds from a part of making good current depreciation (depreciation funds), from normal new investment (additions to capital) and from selling gold

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[2] W.K.Hancock & M.M.Gowing - British War Economy (London, H.M.S.Office), p.19.

and foreign investments and borrowing abroad.[3]

In most underdeveloped countries where the income tax machinery (even in time of peace) is not well established, there is little scope for taxing to bring in much funds for the war. In most countries of South and Southeast Asia, the personal exemption level for income tax is two or three times below that of the United Kingdom and only a tiny minority of the population pays any income tax. Borrowing is not an effective policy as there is a low margin for saving. They are not industrialized to any considerable extent. Thus for war finance, which means they have to import more than they export, they have to rely on foreign debt, gifts, grants and aids. In some of these countries, e.g. Indonesia, devaluation is practised but it is never a beneficial policy in the long run.

Inflation is the increase in the supply of money without a corresponding increase in the supply of goods and services on which it can be spent. Higher prices are only one of the results of inflation. To check it therefore it is necessary to control the prices and at the same time to withdraw from the market an adequate proportion of consumers' purchasing power, so that there is no longer an irresistable force impelling prices upwards. If the law prevents prices from rising without reducing the supply of money in circulation, inflation has other consequences one of which is the black market. It might perhaps have been expected that when expenditure on essentials was strictly restricted by price controls and rationing, people would have spent all the more on things which are not limited by controls and that the price control of everything outside the scope of rationing would break down. But the scarcity of supplies is itself a deterrent; people will not waste time and trouble on looking for objects of expenditure when anything they want is very unlikely to be procurable. Moreover controlled prices of non-essentials, though not so high as the shortage might have led to in free markets, are not low enough to be an attraction. If the quantity of resources which the authorities are prepared to release for civilian consumption is strictly limited, price fixing practices are likely to end in shortages in the shops and queues of unsatisfied purchasers. As such price control and rationing should go hand in hand as the latter diverts consumption in as fair a way as possible from an article, the supply of which has to be restricted for special reasons. The wage level is the most fundamental factor in inflation. The price level when it outstrips the wage level can be brought down again without

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[3] J.M.Keynes, op. cit., p.15.

serious dislocation, but the wage level once raised resists reduction. Wage control is therefore one of the ways to resist inflation though it must not be practised exclusively. With income taxes and taxes of other kinds in wartime, e.g. excess profits tax and sales tax, the excess money in supply can also be absorbed. Another alternative is by voluntary saving and deferment of pay. The choice between these drastic and equally effective alternatives must be decided on consideration of public psychology, social justice and administrative convineance.

Capital flight can be prevented by the government assuming direct control over them. Rules can be passed against such a flight and a strict agency for exchange control can be set up. Only a list of necessaries are to be imported so that no external resources and the country's resources are wasted.

In restricting civilian demand for resources, only the essential civilian needs are maintained. Controls of imports and labour enables the government to limit the supplies coming into civilian use. So far as staple foods, clothes and some other essential civilian needs are concerned, demand can be limited at source by rationing. Civilian production can be restricted by the withdrawal of portion of the productive resources at its disposal or other methods such as taxation, rationing, prohibitions and limitation of supplies. As a last resort, more direct methods can be introduced when necessary.

The question of social justice enters into the scope of War Finance and many writers suggest that the rich should be taxed more than the poor and the latter be given subsidies and allowances. This is not to say that only the rich has to pay for the war but that a suitable proportion of each man's earnings in the poor group take the form of deferred pay. In case of public borrowing, the rich becomes richer with the interests gathered from the bonds and loans while the poor becomes poorer. Raising funds through taxation and the deferment of pay is therefore a better policy in the light of better equitable economic burden. With the subsidies and allowances, they can thus be assured of the maintenance of adequate minimum standards of life. With subsidies, a minimum ration of consumption goods can be made available at a low fixed price.

CHAPTER IV

WAR FINANCE IN WESTERN COUNTRIES

This chapter is devoted to experiences of war finance found during the two World Wars in Western countries particularly those in Great Britain, Canada and the United States.

For Great Britain, the century since 1815 had seen no major war and government spending on defence formed only a very small part of the national income. The minor wars in which Britain had fought had taken only a small part of the national resources, and these had been mobilised easily enough by the ordinary mechanism of the market. The first World War however involved the cutting of living standards to the barest minimum and the rapid mobilisation of the resources in existence. She was thus faced with an entirely different proposition of which there was no experience of a similar crisis to guide her leaders.

The government adopted the method of direct control to mobilise resources whereby it took possession of the goods and services which it needed, and allocated them to a system of priorities based on its own estimate of its military needs. Laws were passed and controls were imposed to see that war effort was not undermined by civilian's demand. Trading with the enemy was prohibited; also prohibited was the export of certain articles of food and warlike stores. Agriculture was given an important position for the government realised that if the farmers were to fail in their war-time task, the country could escape starvation only at the cost of restricting its imports of raw materials or curtailing its military activities. Government took possession of the railways, took the purchase and distribution of sugar out of private hands. With an amendment to the Defence of the Realm Act, the government was given the power to take over and use any factory and workshop. For the supply of Service manpower, the instrument was military conscription; for maintaining a just equilibrium between the Services and industry, the instrument was the Schedule of Reserved Occupations. The rise in prices caused a further extension of control. The high cost of living caused much discontent among the workers and to prevent industrial disputes, Government imposed restriction of the right to strike and other such measures.

Great Britain went further than any other European country in her attempt to finance the war in part with tax revenues. About twenty per cent of her war expenditures were met in this way. Tax revenues increased from 211 million pounds in 1914-15 to 842 million pounds in 1918-19.[1]

The income tax rates were increased and the exemption limit reduced; duties on alcohol were heavily increased; excess profits duty was introduced. There was the famous Mc Kenna duties of 331/3 per cent ad valorem on cars and motor cycles, cinema films, clocks and watches and musical instruments. There was an increase in entertainments duty and in tobacco tax, the raising of postal charges and the imposition of new motor licence duties.

The rest of the finance needed was procured through the printing of notes (the famous 'Bradburys'), borrowing from the public and banks and by external loans. Borrowing was done by the issue of Ways and Means Advances and Treasury Bills, War Loans, Exchequer Bonds and War Savings Certificates.

Money supply was substantially increased causing wartime inflation. According to Hartley Withers the deposits in the commercial banks increased from 1,033 million pounds in 1913 to 1,988 million pounds in 1918. The total circulation of notes and coins in the United Kingdom was 168 million pounds in 1913 to 489 million pounds in 1918. With the reduction in the supply of goods and the increase in the supply of money, price rising was inevitable. Attempts at price control were made but it was not effective in checking the inflationary situation. The cost of living index rose from its base of 100 in 1914 to 278 in 1918.

The costs of the second World War in Great Britain were met by increased output, reduced consumption, reduced domestic capital expenditure and drawing on overseas capital (sale of gold and capital assets abroad, borrowing abroad and piling up of sterling balances by empire countries). War expenditures of the British Government mounted from 358 million pounds in 1938 to 4,678 million in 1944.[2] This was covered partly by increased taxation (to curtail civilian demand and so release resources for war use), which rose from 21 per cent of national income in 1938 to 35 per cent in 1944. It has been said that in 1938, the individual citizens of Great Britain spent 76 per cent of their incomes, paid 21 per cent in taxes and saved the remaining 3 per cent. In 1944, they spent only 54 per cent, paid 27 per cent in taxes and saved as much as 19 per cent.[3] Income tax rates

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[1] Lawrence Smith - <u>Money, Credit and Public Policy</u> (Houghton Mifflin Co., Boston), p.241.

[2] Ibid., p.269.

[3] Geoffrey Crowther - <u>An Outline of Money</u> (Thomas Nelson & Sons Ltd.), p.169.

were further increased, there was a reduction in allowances and relief and there was a sharp increase in indirect taxation. Forced savings were introduced and undistributed profits had to be invested in government securities. Rate of interest was fixed at three per cent and there were controls on capital issues and bank advances. Public debt rose from 7,269 million pounds on March 1, 1939, to 23,744 million on March 1, 1946. About one-quarter of government obligations were sold to banking system, which was a smaller percentage than in the United States. Currency and bank deposits increased from 1.65 billion pounds at the end of 1938 to 4.41 billion pounds at the end of 1945.[4] Price level rose but at a lower level.

As the war continued, the civilian claims upon the war economy were severely reduced. The reduction in the standard of living was throughout determined largely by a process of trial and error and the prevailing balance of opinion about public psychology. Food provided an outstanding example. Significant reductions in the quantity or the variety of diet, even temporarily, were strenuously resisted on the grounds that they would impair health and the ability to work. In order to ensure that the limited supplies of labour and materials remaining in the private sector were used to the best advantage, production was permitted only under licence. Licences were granted for nothing except essential articles made to approved specifications. Because civilian production was cut two years earlier in the United Kingdom than in Canada and the United States, the United Kingdom ran down its stocks much sooner.

Inflation was less in the second than in the first World War. This can be attributed to the decline in the proportion of incomes spent and to the rigid price control and rationing. Savings of household increased from 7 per cent of income in 1938 to 19 per cent in 1944. Foreign exchange control prevented capital flight and conserved the limited supply of foreign exchange to pay for the most necessary imports. The high cost of living was made bearable with cost of living subsidies, rationing and price control, and allowances.

The outbreak of the first World War in Canada was a time of business recession and of declining government revenues, these being closely tied to the movement of imports. The methods available to the government to raise funds were direct borrowing and the issuing of fiduciary notes. The loans were acquired from Britain and the United States. In 1915 special war taxes appeared for the first time and later business profits tax was introduced. In 1917

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[4] Lawrence Smith, op. cit., p.269.

a personal income tax was introduced and the government undertook its intensive effort to effect a widespread ownership of war loan bonds. Customs duties continued to provide a major source of revenue throughout the war. Almost the entire costs of war activities were met by borrowing and later borrowing depended increasingly upon the domestic market.

The loans and issues of fiduciary notes led to an increase in the money supply creating an inflationary situation. This rapid increase in money supply was primarily responsible for the sharp rise in wartime price levels. Various factors contributed to the success of the Canadian government in raising very large sums of money in the domestic market during World War I. They included the increase in value of Canadian exports, the decline in private investment , the increased saving through patriotic motives and the role played by inflation and the consequent expansion of profits. The rudimentary tax system in existence explains the inadequacy of tax revenues at that time. The inequities of the programme of war finance which occured in 1914-18 were tolerable in a situation where the government's war expenditures absorbed not more than 10 per cent of the national income.[5]

The Second World War was initially met by using the substantial unused productive capacity and of unemployed labour. The need for reallocation of resources was accomplished by the introduction of various measures and direct controls, e.g. direction of manpower and control and rationing of supplies. The government adopted a policy of war finance in which the pay-as-you-go objective was pursued to the limits of practicability; additional financial needs were met by a programme of borrowing from the public at the lowest possible interest rates. Short-term bank borrowing was adopted and various additional taxes were imposed. A Foreign Exchange Control Board was set up controlling over all financial transactions between Canada and other countries. The sale of War Savings Certificates and Stamps and of non-interest bearing certificates was introduced in 1941.

For reasons both of equity and expediency the increases in direct commodity taxes were to be minimized. The government relied more heavily on direct taxation. Wartime tax yields increased rapidly with the introduction of new taxes and the sharp increases in the rates of existing taxes. Borrowing from the public was done using the instruments of War and Victory Loans, War Savings Certificates

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[5] R.Craig Mc Ivor, op. cit., p.115.

and War Savings Stamps. Inflation was fought with taxation, saving, price control, wage control and rationing. In terms of percentages, the general public provided 85 per cent of all new funds, the Bank of Canada 3 per cent and the chartered banks 10 per cent. The sale of treasury bills by public tender provided the remaining 2 per cent.[6]

It can be seen therefore that while in World War I, the Canadian government met the entire costs of the war by borrowing, in World War II it was met not only by borrowing but also through taxation (personal income tax, corporation income tax, excess profit tax) and other revenues which provided 44per cent of the greatly expanded cash requirements. Inflation was less in World War II and considerations of equity were notably absent in the earlier period. In general, it may be said that the whole economic approach to the problem of financing World War II was sounder than in the earlier period, and the monetary-fiscal techniques available for implementing the programme were much better developed.

The total cost of World War I to the United States was about 35 billion dollars, including 9.4 billion dollars loaned to the Allies after April, 1917. The national debt rose from about a billion dollars before the war to over 26.5 billion dollars in 1919. This financial obligation was met in part (about one-third) by taxation and in part (about two-thirds) by loans.

The income tax, which was increased in 1916 and again in 1917, produced about two-thirds of total tax income. The Act of October 3, 1917, imposed an excess profits tax, and increased the taxes (or imposed new taxes) on liquors, tobacco, luxuries and amusements. Loans were acquired by means of five bond issues - the Liberty Loans and the Victory Liberty Loans. The bonds were purchased by an estimated total of 66,000,000 Americans.

The shortages of resources and the government's liberal credit policies led to steady price increases resulting in war inflation. The cost of living rose during 1918 about 75 per cent and during 1920 nearly 110 per cent above the 1913 level.

The World War II in the United States was financed by heavy taxation and extensive borrowing. As far as the mobilisation of resources to war effort was concerned, controls were introduced. Thousands of plants that normally made peacetime goods participated in war production. From 1940-45,

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[6] R.Craig Mc Ivor, op. cit., p.192

the total labour force rose from 54 to 64 millions, an increase of more than 18 per cent. Absorbed into the labour force were the unemployed, young people, the aged and women. From 1939-44, there was a twenty per cent increase in the average work week. The Smith Connally War Disputes Act, passed in June, 1943, required unions to give 30 days' notice before a strike vote could be taken, empowered thw President to seize war industries threatened by work stoppages, made it a criminal offense to forment or aid strikes in government-operated industries and forbade unions to make contributions to political campaigns.

The budget for 1941-45 exceeded a total of 317 billion dollars of which 88 per cent went to war purposes. The federal debt rose from 48.9 billion dollars in 1941 to 258.7 billion in 1945. Taxation was imposed to fight inflation as well as to raise revenue. The category of individuals paying income taxes was expanded to include all persons earning 500 dollars or more in a year, and surtaxes ranged from 19 to 88 per cent. A method of withholding taxes from salaries and wages began in 1943. An excess profits tax was levied on corporate income and heavier excise taxes were adopted. Total receipts from taxes in the period 1941-45 approximated 138.5 billion dollars. From May 1941 to January 1946, the government sold securities amounting to 185.7 billion dollars. It is estimated that private individuals bought 53 billion dollars' worth of this amount while banks and corporations absorbed the rest.

Wartime inflation existed due to the huge government expenditures, full employment and increasing scarcity of civilian goods. However it was met more effectively than in World War I. The Price Control Act (January 1942) established the office of Price Administrations with authority to fix maximum prices, to control rents, and to impose penalties on violators of the war. Rationing was introduced and by mid-1943, 95 per cent of the nation's foodstuff was rationed and maximum prices and rents had been established.

In terms of money costs, World War II was much more expensive than its predecessor.[7] The costs were financed through taxation, extensive borrowing from the public and the banks and external loans. The resulting increased in money supply together with the shortage of civilian goods made price rising inevitable. Inflation was world wide but in general it was much less in the second World War than during the first World War. This is because of the larger extent of price controls and limitations of purchasing by rationing

[7] Lawrence Smith, op. cit., p.268.

and allocations practised in the later period. The increased in money was more than proportionate to the rise in prices in most countries. Hyper-inflation was experienced only by Italy, Korea, Greece and China.

CHAPTER V

WAR FINANCE IN MALAYSIA

Malaysia comprises the former Federation of Malaya, the former self-governing State of Singapore and the former British colonies of the North Borneo and Sarawak and was formed on 16th. September 1963. She was occupied by the Japanese during World War II and since her liberation, she has not been involved in any war. The emergency in Malaya (fighting against Communist terrorists) ended in 1960 and at present Malaysia is faced with confrontation from Indonesia. This chapter is an attempt towards a theoritical approach of how Malaysia might finance her war in case a war breaks out. Before this, however, it would be beneficial to have a rough picture of the Malaysian economy.

With the exception of Singapore, the Malaysian economy is to a large part rural. The reconstruction after World War II in Malaya involved primarily the modern sector: mines, estates and urban areas. It was a development that left the traditional sector, that of the Malayan peasant and fishermen, largely untouched. Under the colonial government, rural development continually suffered from lack of funds which was largely taken up by the Emergency. In the 1950s, steps were taken to develop the rural areas and this has been the government's policy since Malaya's independence in 1957. In 1950-51, the Rural and Industrial Development Authority was formed followed by the Federal Land Development Authority in 1956 and the Ministry of Rural Development in 1959. For Sarawak and Sabah, there was a similar change in policy to develop the rural areas but the change was less pronounced than those experienced in Malaya. Singapore, a free port, is developing at a faster rate than the other three states and has enjoyed and is still enjoying her entrepot trade.

As most of the countries in Asia, Malaysia exports mainly primary products and she ranks as the world's largest producer of natural rubber and tin. The other major primary products are iron-ore, palm oil and timber. She depends on the proceeds from exporting these products to get the foreign exchange necessary to pay for her imports and export taxes form a very large part of her government's revenue. The proceeds from rubber are decreasing because of a lower price and for RSS No. 1, the average price in the first eight months of 1964 was only 67 cents per pound. The price of tin has increased but the response from production is not great due to limited reserves; Malaysian production is expected to reach a figure of 59,000 tons this year against a figure of 60,000 tons for 1963.[1] To finance her ordinary expenditure and development programmes, the Central Government relies also on import duties, excise, income taxes, grants and borrowing. The overall budget deficit of the Federal Government in 1963 was 356 million dollars. This was partly financed by domestic borrowing ($210 million), foreign borrowing ($60 million), Government's accumulated assets ($78 million), and a net credit ($8 million) arising from the operation of various trust funds.[2] The Malaysian economy is however susceptible to external conditions (resulting from changes in demand or prices of her products), and this is largely responsible for her periods of "booms and slumps". A good illustration of her boom period was provided by the outbreak of hostilities in Korea. The problem is to expand and improve rubber production as well as to use every opportunity to develop other lines of agriculture and industrial production so that the economic future of Malaysia will be less closely bound to the annual variations and long-run fortunes of rubber. Malaysia is also not a self-sufficient nation and she imports an important part of her food requirements, the largest item being rice.

In a situation where the outbreak of a war is imminent, one of the tasks of the Central Government is to mobilise all the available resources to war effort. Malaysia has no munition industry of her own and this has to be imported but wherever possible the existing plants and machinery should be converted for war purposes. Labour can be increased from the unemployed (7.6% of total male labour force and 5.4% of total female labour force in 1964), women, children and those retired; retirement age can be raised and labour can work overtime; all those who are not working to their capacity can be absorbed. Labour has to be trained and provided with equipments at high cost and war equipments imported have to be paid for. The government has therefore to raise sufficient funds to meet her huge expenditures.

An important revenue getter for the government of Malaysia is the proceeds from the export of primary products. Steps must be taken to see that there is no decline in the volume of their exports (both in the plantation sector as well as in the small-holdings or private sector) for any decrease will result in a lower revenue because of a fall in revenue from export duties, a decline in personal and corporate income tax revenue and a decline in revenue from import tariffs. At present, the scheme to assist rubber producers in carrying out a massive replanting programme to replace

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[1]See <u>Finance Minister's Budget Speech 1965</u>.

[2]Ibid.

over-aged and low yielding trees with high yielding materials has proved to be an effective way to increase production as well as to prepare the industry to meet the challenge of synthetic rubber. Provided with financial assistance from the replanting cess on smallholders rubber and the Government, 308,000 acres have been replanted and holdings have been extended by 86,000 acres. Similarly, the estates have replanted 357,000 acres and extended their holdings by 79,000 acres.[3] The major export duties are those on rubber, tin and iron. They are related to their respective prices and the percentage varies; e.g. for rubber, the rate of duty starts at 4% ad valorem when its price does not exceed 60 cents a pound and rises to almost 25% ad valorem if and when the price ever reaches $1.50 per pound. Total revenue from export duties in 1962 was 178 million dollars.

At present only some of these export industries are financed by foreign capital. The seriousness of seeing that the production of these primary products are unhindered is seen in the case of capital flight. In the event of a war being declared, the formation of new capital becomes nil or at its lowest level; those having interests in this country (both foreign and domestic) will transfer their capital overseas for the chances of them being destroyed, confiscated or fall in value are great. This will definitely mean the total collapse of the economy. As such steps must be taken to prevent any capital flight and foreign exchange control be set up to make full use of the foreign exchange available.

In the subsistence sector where rice forms the largest and important part, steps must be taken to increase its production such as the increase emphasis on mechanisation and new colonisation. It must be emphasised that it is the amount of rice and not the number of rice growers that is important. Provided that there is much higher output per man, some drift away from the rice fields ought to be encouraged, for it is probable that only so can high output per man be achieved. The excess labour can be utilised in other fields to meet the war. At present, the production of padi is increasing as a result of the larger availability of irrigation supplies, the successful extension of double cropping experiments with improved varieties of padi and the use of fertiliser including urea, supplied through cooperative societies and the abolition of the "padi kuncha" system of borrowing by the supply of credit through the cooperatives.[4] The availability of food supply at home means there is no danger of the termination of food imports in war and the foreign exchange formerly used to purchase food from out-

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[3]See <u>Second Five Year Plan 1961-65</u>.

[4]Ibid.

side can now be used to purchase war equipments.

The composition of the imports too have to be changed and controlled. Steps should be taken to see that the imports consist only of the goods required for war. Any others, such as equipments needed for development purposes, luxuries and unessiential goods, have to be postponed or prohibited.

As to the entreport trade of Singapore and Penang, there will be a danger of a narrowing of the range of their trade and consequently the Government's revenue. Singapore has developed as an international centre for the Far East. With the great growth in the scale of individual businesses and also in the total trade of the Far East, many firms have branches throughout the Far East and tend to establish head offices in Singapore. Oil is perhaps the most important. Sales of many goods and services is organised through Singapore and she is also an important air centre. Together with Penang, she has become important centres of rubber milling and tin smelting, serving Malaysia and neighbouring countries. Steps to prevent the collapse of their entreport trade should be undertaken swiftly such as the prevention of capital flight and other direct measures. This is perhaps a difficult task but nothing can be left to chances.

The Currency Agreement of 1960 provided for the Currency Board to make a fiduciary issue of up to 300 million dollars - $200 million to Malaya, $60 million to Singapore and $40 million to the North Borneo territories. This can be resorted to as a temporary measure (during the initial stage) for the disadvantages of an over-issue of notes are well-known. In Malaya, during the Japanese occupation, the over-issue of the "banana currency" led to serious inflation and black marketing.[5]

The tax system in Malaysia is well developed in relation to countries in Asia but by Western standards, their rates are lower. Revenue can be increased with higher rates in income taxes and a reduction in the exemption limit. At present the highest personal rate of tax is 50%, that of company at 40%; a single person receives personal relief of $3,000 in Sabah and Sarawak compared with $2,000 in Malaya and Singapore and a married man $5,000 compared with $3,000 in Malaya and Singapore. Income tax accounts for over 20% of Federal Government revenue. The Finance Minister of Malaysia in his budget speech for 1965 says that "a top personal rate of 50% and a company tax rate of 40% are by no

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[5]For further detail on the Japanese occupation in Malaya, see Chin Kee Onn - Malaya Upside Down.

means the highest in the world."[6] The pay-as-you-earn scheme can be introduced. Government's revenue can also be 'increased' by deferring the pay of its workers and this has the advantage of reducing the money supply available to the people. Excess profits tax can be introduced to absorb windfall profits made by some people as a result of the war; the present rates of payroll tax (2% on total payroll) and capital gains tax (a standard rate of 20%) can be increased. Increases in the rates of indirect taxes and the introduction of new ones can also raise Government's revenue. About one-third of Federal Government revenue is derived from import duties. To ease the burden of the people in the lower income group, higher indirect taxes on items of luxury and less essential commodities should be imposed. The Government can also postpone or eliminate its less important expenditures and those which are not productive and stop unessential imports.

Another source of funds is by borrowing from the public including the commercial banks. The raising of domestic loans in the past for development purposes had shown the great amount of funds available from the public. The banking system in Malaysia is well developed. In the first half of 1964, loans and advances by the commercial banks to the private sector increased by $170 million or 10.2% above the amount outstanding at the end of 1963. The commercial banks also lent an additional $48 million to the government largely in the form of Treasury Bills. A large part of their assets are invested overseas and this can be borrowed by the Government by issuing bonds and treasury bills. The Central Government too has its own reserves accumulated in the past but their limit to finance a war is obvious. The Post Office Savings Bank and the Employees Provident Fund are two major sources of Government borrowing. The public can be encouraged to save (or forced as a last resort) and their savings can be mobilised to assist Government spending, e.g. sale of War Bonds, Defence Stamps, etc. To encourage saving, the Post Office has increased its interest rate from 2½% to 3% per annum this year.

External loans would cover the remaining gap between the raised funds and the increased expenditures. The great confidence in the Malaysian currency (due to the present political and economic stability) will ensure the availability of such loans but the rate of interest should well be considered. Under her Defence Agreement with Malaysia, Britain has pledged to help her from any outside aggressor. Grants and aids can therefore be expected from

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[6]See _Finance Minister Budget Speech 1965_.

the British Government. Finally Malaysia has only one enemy- the Communists- and thus she can be sure of aids from the United States of America, the Commonwealth as well as other free nations.

Inflation is inevitable in war with rising expenditures, increasing scarcity of goods available to the civilian and the likely demand for higher wages by the workers to meet the high cost of living. The Central Government has therefore to employ measures and controls to ensure that the inflation does not get out of hand and lead to undesirable consequences. A direct measure would be to control prices and wages. However price controls must be accompanied by rationing or it will only lead to shortages and black marketing. Furthermore the money supply available to the public will be reduced by heavy taxation, increased savings and the deferment of pay.

It is natural in war for the Government to compete with the public over the resources available. It can assume direct controls over resources, e.g. restriction on building construction. Other than war materials, only the essentials are to be imported for the civilian population. The setting up of a foreign exchange control would see to it that there is no wastage in the foreign exchange available to the civilian.

As to equitable distribution of burden, the method of raising revenue by taxation is much better than by borrowing. Only the rich has funds available to lend to the Government and this will make them richer with the interests paid. With taxation on a graduated scale, all will share the burden equally but the poor can be slightly relieved by subsidies and allowances.

Despite the present confrontation by Indonesia, Malaysia has enjoyed prosperity and development in her economy and the air of confidence and stability of her economy is reflected by the increasing inflow of private foreign capital. It is obvious that Malaysia, like any other Afro-Asian countries, cannot finance a war more so when the war is a long drawn and huge one. Nevertheless, as often, a war is never welcomed and it is hoped that Malaysia will never be involved in any war.

CHAPTER VI

CONCLUSION

In modern society, there is no doubt that war creates great upheavals in the monetary system and the price level. It induces not only inflation but leads to secondary consequences. The main problems include the diversion of resources, damage to property and the need for increases in government funds to finance the war. The necessary production or importation of war equipment, the mobilisation of all available resources to meet the war all need the help of the financial system to bring them about. The volume of government spending in a serious and prolonged war thus creates difficult problems of public finance.

Government goes about to finance a war by resorting to increasing tax levies and borrowing. The need for borrowing becomes obvious considering the limitation imposed on the issuing of 'fiat' money and the amount that can be got from taxation. War effort requires an expansion in total output and hours of employment leading on to some monetary expansion. Whether this is desirable or not depends on the authority concerned, but it is true that monetary expansion is needed (in fact inevitable) in a war. For example the workers employed from the unemployed, women and children have to be paid for; to make them work overtime, monetary rewards must be given. As has been noted already, the increase in money supply together with other economic dislocations with the outbreak of war result in price inflation. Next to the chief objective of winning the war is therefore to avoid such an inflation.

One of the ways to prevent inflation is to avoid the expansion of money supply in the country. The most common method is to introduce a prompt and drastic programme of taxation. Taxation has the advantages of reducing the supply of money in the public available for spending and providing part of the funds of the government to finance a war. The public, through propaganda, can be voluntarily persuaded to save part of their income and invest it in government bonds. If this is not forthcoming, a scheme of compulsory savings can be imposed e.g. the Provident Fund in Malaya. With rationing, people can purchase goods only up to the amount allotted to them; this means the remainder of their income is available for saving thus increasing the amount of savings possible. It must be stressed however that such rationing must be followed by price controls or it would lead to higher prices detrimental to the lower income groups. Producers' goods can also be rationed to prevent any waste on non-war effort. Borrowing by the public from banks can be discouraged by maintaining interest rates at a high level or government can control the direction of bank advances. Wherever possible the output of goods must be expanded as one of the ways to meet the increase in the supply of money. Other methods include wage control and by paying the workers partly with bonds instead of cash.

Two reasons made it necessary for rationing and price controls during wars. The first one is the scarcity of commodities. Wars naturally involve the destruction of goods making them scarce; the high demands of the military sector lead to a reduction in the goods available to the civilian sector. The great increase in money supply results in increasing prices for those goods, leading to a price inflation which is the second reason that makes it necessary for the introduction of price controls and rationing. Price controls cannot obtain their objective without coordination and the help of other measures. It will help however if there exists a general public acceptance of controls as a war necessity. The importance of price controls reveals itself in the post-war period where without its maintenance, a serious inflation often results.

At present a country at war can hardly restrict it within its own frontier from becoming an international affair. One can imagine the devastating state of affair and possibly the total annihilation of mankind should another World War develop. The setting up of the United Nations Organisation has so far succeeded in preventing another World War from materialising and various other peaceful organisations have been developed aiming at the preservation of peace. The importance of having some knowledge of War Finance must not be underestimated. Should a war happen, then with a good knowledge of financing the war, the obstacle can be met without much economic dislocations that could topple the country even after victory.

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