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INDIAN CURRENCY, BANKING AND EXCHANGE

INDIAN CURRENCY BANKING AND EXCHANGE

BY

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PREFACE TO THE SECOND EDITION

This second edition is not a mere reprint of the previous one. Two new chapters have been added and the text has been thoroughly revised and brought up to date.

The encouragement I have hitherto received both from University teachers and the general public leads me to hope that this second edition will prove useful to those for whom it is intended.

Delhi, 1932

PREFACE TO THE FIRST EDITION

This book is a reprint of the first part of my *Indian Currency and Exchange* with the addition of two new chapters, one on Indian Currency and Exchange during 1924-8 and the other on the Money-market and the Banking System in India. It is intended primarily for candidates preparing for the pass degree in Economics, but it has been put into a form that will be comprehensible to an intelligent person of an average education who has had no previous training in currency and banking problems. An attempt has been made to make this volume as non-controversial as is possible in a subject like Indian currency, all controversial matters being relegated to a separate volume.

It is gratifying to me to find that almost all the suggestions that I had made for the reform of the Indian currency system in the first edition of my

Indian Currency and Exchange—the convertibility of rupees and notes into gold bullion, the demonetization of the British sovereign, the amalgamation of the Paper Currency and Gold Standard Reserves, the location of the greater portion of this combined reserve in India, the accumulation of a large gold holding, the creation of a central bank to assume control of both currency and credit—were accepted by the Hilton Young Commission on Indian Currency. On one important issue, namely the question of stabilizing the gold value of the rupee, the recommendations of the Royal Commission ran counter to the course I suggested; but I claim that the actual course of events has amply vindicated my opposition to the policy of stabilizing the rupee-gold exchange at a time when the course of world prices was still uncertain.

The reader who is anxious to know my views on controversial topics should refer to the second part of my *Indian Currency and Exchange* published in 1925, my evidence before the Hilton Young Commission in 1926, and my brochure on *Some Aspects of the Indian Currency Problem* published in 1927. My contributions embodied in these publications are being brought out in an amplified form in a separate volume entitled *Studies in Indian Currency and Exchange*.

Delhi, 1929 H. L. CHABLANI

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CHAPTER I

THE INDIAN RUPEE

1. In the civilized life of the present day, human beings satisfy their economic needs by means of a complex organization, based on division of labour and exchange of commodities and services. They do not, however, exchange *directly* what they do not want for that which they want; they carry on their business of exchange through an 'interposed commodity', called money. They do not barter one commodity for another; they *buy* and *sell* commodities with 'money'. The reason why they resort to this course lies in what Jevons calls 'want of coincidence in barter'. The difficulty in barter is 'to find two persons whose disposable possessions mutually suit each other's wants. There may be many persons wanting, and many possessing those things wanted; but to allow of an act of barter, there must be a *double coincidence,* which will rarely happen'. These inconveniences have been avoided in civilized life by the use of some universally acceptable commodity as a *medium of exchange*—a commodity which 'every one shall receive in exchange for what he has but does not desire personally to consume, in the confident assurance that with it he can, at any time, and of kinds and in quantities to suit his immediate wants, obtain from others what they have but do not desire to use'.[1]

A medium of exchange once adopted can serve, and does serve, another purpose, that of a common *measure of value,* in terms of which the value of all other things is obtained; for, as Mill tells us, 'it is easier to ascertain and remember the relations of

[1] Walker, F. W., *Money.*

many things to one thing, than their innumerable cross-relations with one another.'

If the commodity chosen as a medium of exchange and as a measure of value is not liable to decay or to vary much in value, it becomes useful for the purpose of expressing fairly accurately the relations of debtors with creditors to the satisfaction of both parties. In other words, it will perform the function of a *standard for deferred payments.*

Now it is quite possible to employ one substance as a medium of exchange, a second as a measure of value, and a third as a standard for deferred payments. But it is certainly more convenient to select one single substance which can serve all these functions. Such a commodity is called 'money'.

Obviously, no commodity can perform these functions satisfactorily unless it is universally acceptable. The force of law or social convention can make *anything* universally acceptable for a time. But the only sure basis of general acceptability for *long periods* and up to almost *unlimited* extent lies in the intrinsic value of a commodity as a commodity, apart from its legal or conventional value. Hence the phrase 'true money' so commonly used to signify the quality possessed by a standard of value whose market value as a commodity equals its value as fixed by law.

This would be the case in all countries where the mints are 'open to free coinage' of silver or gold. In such countries, Government fix a certain price which they are willing to pay for gold or silver of a certain standard, and undertake to coin practically free of charge any quantity of bullion that the public may bring to the mint at a certain fixed number for a specified weight of the particular metal. In such circumstances, the value of the metallic coin can rarely (and then, too, for only a short period) *exceed* the market value of the metal as a commodity, for people can easily convert bullion into coin if there is any appreciable difference between the two. Nor can

the value of the metallic unit of currency fall *below* its value as bullion in the market, for it can easily be melted into bullion and sold as such.

Such a standard coin, freely minted, is easily accepted by people in the transactions of everyday life up to unlimited amounts and though the laws of these countries declare formally that such a coin is unlimited legal tender, acceptable by the public in payment of debt, no compelling power of the law is really necessary to make it acceptable to the public *in fact*.

In most countries, however, there are, freely in circulation, certain coins whose denomination is not really in accordance with the value of their material or weight. They are generally intended to satisfy the need of the public for some medium of exchange and measure of value in transactions of small value, and are, therefore, generally *limited* legal tender. For example, the English shilling is by law equivalent to one-twentieth part of a sovereign, though the silver in it would fetch much less than this in the bullion market. It is legal tender up to forty shillings only. Such a coin is generally known as a 'token coin'.

2. It is easy to see which of these propositions is applicable to the Indian rupee. It performs all the functions of money. It is the principal medium of exchange and measure of value in India and it does serve, though not very satisfactorily, as a store of value and a standard for deferred payments. But it is not what is popularly called 'true' or 'natural money'. Its value as a coin is much above its value as silver, and it is, in this respect, in the same position as the English shilling. But unlike the latter, it is *unlimited legal tender* and fulfils largely the other requirements of 'standard' money.

In the numerous polemics on Indian currency, the Indian rupee is freely called 'a token coin'. That statement is true in a sense, if properly understood;

but it is likely to mislead the unwary reader into thinking that the rupee in India resembles the English shilling more than it resembles the English pound. As a matter of fact, this token rupee is *the standard* money in India, for 'as long as the *main* currency is in rupees, all contracts are made and taxes calculated in rupees, all transactions effected in rupees, and rupees are legal tender to any amount, *the rupee is really the standard*'.[1] If then the rupee is still called a 'token coin', it must be remembered that it is a *token currency of a peculiar kind*—a token currency which is more widely used than the nominal standard, a token currency which is unlimited legal tender and the chief measure of value in India. It may be called 'a standard token coin', if such an expression is permissible.

It must be clear at this stage that the value of the rupee could not exceed appreciably the value of its silver contents, as long as the Indian mints were open to the 'free coinage' of silver. This was the case till 1893. During this period of 'open mints', the value of the rupee was 'natural', and not 'artificial', determined by the market price of silver, and not by any Government fiat or manipulation. Under the conditions then existing, the expansion and contraction of the rupee circulation was perfectly automatic, regulated by the conditions of trade and commerce, internal as well as external. If business was brisk and harvests were abundant, the public could easily increase the amount of rupee circulation by converting silver into rupees at the Indian mints. If trade was slack, the business community depressed, and rupees in circulation redundant, the public melted rupees into silver and thus effected a contraction of circulation. Government, as Government, had practically no control over the expansion or contraction of currency.

[1] Sir Samuel Montagu's evidence before the Chamberlain Commission.

Things, however, became different after the *closing* of the mints in 1893. The Government of India then assumed charge of the work of adjusting the volume of India's currency to the ever-varying requirements of her business and trade. Ever since then, Government have been creating as much or as little of the standard token money of the country as they have thought justified by certain indications of an elaborate mechanism, the details of which we shall examine later on. Whether the system devised by Government resulted in a natural or automatic expansion and contraction of the currency, as is claimed by the official exponents of the system, or whether it left everything to the caprice of Government, as is alleged by its critics, is a question which will be discussed later on. The point to note at this stage is the establishment of a *Government monopoly* in the supply of currency. The closing of the mints prevented private individuals from establishing equilibrium between the value of the rupee and the value of its silver contents. Thereafter, the value of the rupee was completely divorced from that of the silver in the rupee. The rupee, as already remarked, became a standard token money.

3. Something still remains to be said if the pre-War position of the rupee in India is to be properly understood. The rupee was not the only unlimited legal tender in India. The British sovereign, too, shared that honour and the law of the country fixed its value at fifteen rupees up to 1917, and at ten rupees between 1920 and 1927, in theory at least.

Since the external value of the rupee was a fixed fraction of the British sovereign, the pre-War Indian currency system was sometimes described as a 'gold standard'. Now this phrase, so often heard in these days, is a slippery one : it is not always used in the same sense. But in spite of a variety of meanings attached to it, almost everybody is agreed that pre-War England had a *gold standard in every respect.*

She had a standard money, made of gold; all other kinds of money in use in England were ultimately convertible into gold money; and her gold money was itself convertible, by melting or export, into *ordinary gold bullion.*

In the years immediately preceding the world war, gold coin was, however, becoming less significant as a constituent of the circulating medium even in England; and since the post-War revolutions in the world's monetary systems, actual circulation of gold coin has ceased to be considered as essential to the existence of a complete gold standard. A leading currency expert defines the gold standard as 'in its essence an abstract standard where the price of gold has been fixed not absolutely but so far that variations of the price are restricted within very narrow limits', or, what amounts to the same thing, 'where the unit of currency has an approximately fixed gold value.' According to these post-War ideas on the subject, 'the *only lasting* and *necessary* feature' of the gold standard is the *fixed gold parity* of the unit of a country's currency, both *internally* and externally.[1] Judged by either the pre-War or post-War conceptions of the gold standard, India was not on the gold standard in pre-War days. The Indian rupee was convertible into gold only on those special occasions when Government offered gold in *London* in exchange for rupees *in India.*

Was the Indian standard then bimetallic? Now, a pure and simple double standard or bimetallism implies two essential elements. Under it, all coins, whether of silver or gold, are made unlimited legal tender for payment of debts; this, no doubt, was the case in India also. But more important than this is the essential condition that under bimetallism both metals are *freely minted;* this was just the opposite of the conditions obtaining in India. Thus, of the two essentials of a double standard—free coinage and

[1] *Hilton Young Commission Report,* vol. III, p. 603.

full legal tender—the Indian currency system lacked one.

Some writers, therefore, called the pre-War Indian currency system 'a limping bimetallism', a name commonly applied to the pre-War monetary system of France, on the ground that under it 'the silver coin, though intrinsically of less value than the gold, hobbles along, maintained at equality by being coupled with its stronger associate'.[1] This, however, was not the only point of resemblance between the two. In both countries, mints were closed to free coinage of silver; in both, silver coins were unlimited legal tender; in neither were silver coins legally convertible into gold; and both depended for their external trade on gold, the international medium of exchange. But here the resemblance between the two ends. In France, silver coinage, except of subsidiary coins, was completely stopped; in India, the coinage of silver rupees was resumed in 1900, and silver continued to be minted more and not less extensively than before. In France, the mints were open to free coinage of gold, and large quantities of gold were not only put into active circulation but also held in reserves; India had neither a gold mint, nor much gold in circulation or in her local reserves. In France, there was no undertaking on the part of Government to redeem their silver coinage in gold either inside the country or abroad; the Government of India, on the other hand, adopted in practice a system of partial redemption, issuing orders, so to speak, for the delivery of gold from their gold reserves or other gold assets held in London.

Some other name was therefore needed to describe the pre-War Indian currency system properly and the label most commonly applied to it was the 'gold-exchange standard'. There was considerable justification for this practice. For internal purposes,

[1] Taussig, F. W., *Principles of Economics.*

the rupee was the medium of exchange and measure of value; for external purposes the British sovereign was the effective standard; and the *exchange* value of the rupee in terms of the British sovereign was an *almost* fixed fraction of the latter. But even this description is not an accurately correct statement of pre-War conditions. As Sir Lionel Abraham pointed out in his evidence before the Chamberlain Commission, the Indian system was *something more than* a gold-exchange system. 'The ideal gold-exchange system would be a system under which there were central stocks of gold under the management either of the Government or of a responsible central bank with little or no gold in circulation.' But the Indian system during the period 1893-1916 was different from that in so far as it sometimes encouraged a certain circulation of gold. 'It was on its way towards becoming a combination of a gold-exchange system and a gold currency system.'

4. What about the Indian currency system *after* the War? It is difficult to characterize it by a single epithet applicable to all the phases through which the Indian currency system has passed since the War. At one period, the Indian rupee was linked to the English sterling, which was then different from the gold contents of the sovereign; and thus the Indian system was more a *sterling*-exchange than a gold-exchange system. At another period, the rupee was made to follow the rising price of silver, and its value then was very nearly the value it would have had under the open mint system. It was then fast drifting to a silver standard. At a third period, an attempt was made to fix the external value of the rupee in terms of gold at the rate of 2*s*. gold to one rupee, and so the Indian system was practically a *dollar*-exchange system, for the American dollar was then the only metallic standard, the value of which was determined by natural automatic conditions. The attempt failed and in the four succeeding years the

Government of India ceased to make any active efforts to maintain an exchange standard of any kind, leaving the Indian monetary standard units practically in the position of inconvertible notes printed partly on silver and partly on paper.

From October 1924, when the external value of the rupee touched 1*s.* $6\frac{5}{16}$*d.* (then equivalent to about 1*s.* $4\frac{3}{4}$*d.* gold), to July 1925, when the rupee became equivalent to 1*s.* $6\frac{1}{16}$*d.* gold externally, the Indian currency system became once again a sterling-exchange standard, the external value of the rupee being maintained by Government within the limits 1*s.* $6\frac{5}{32}$*d.* and 1*s.* $5\frac{27}{32}$*d.* In July 1925, India was brought once again on a *gold*-exchange standard, the sterling being identical with its old gold parity.

As the result of recommendations of the Royal Commission on currency appointed in 1926, the Government of India definitely committed themselves in 1927 to the establishment of what is known as the gold bullion standard. The rupee was to continue to be unlimited legal tender, but was to cease to be the standard form of currency on which all other forms of legal tender depended for their convertibility. All legal tender media of circulation, including the silver rupee, were to be convertible, not into *gold coins,* but into specified amounts of gold *bullion.* Both rupees and notes were to be linked directly to gold and not to sterling or any other currency or group of currencies. The currency authorities were to be bound to give gold bars in exchange for notes or silver rupees at the rate of 8.4751 grains for a rupee, in quantities of not less than 400 fine ounces or 1,065 tolas, not for export only, but for *any purpose.* But no gold coin was to be minted nor were the English sovereign and the half-sovereign to be recognized as legal tender in India. The Indian currency system was to have all the essential features of a gold standard, namely a fixed gold parity of its unit of currency, free convertibility into gold for its legal

tender media of exchange, and free export and import of gold.

Circumstances, however, changed for the worse in September 1931. As the result of an exceptional strain on England, the English pound went off the gold standard on 21 September 1931 and the Secretary of State announced to the Federal Structure Sub-committee of the Indian Round Table Conference in London that 'it was out of the question to follow gold and so increase the sterling value of the rupee' but that it had been decided to 'maintain' the Indian currency 'on a sterling basis' and 'to continue the policy under which stability in terms of sterling has in the past been secured'. Subsequently an ordinance was issued, restricting the sales of *gold* or *sterling* for notes and rupees and conferring wide powers on the executive to impose conditions on these sales. In January 1932 this ordinance was withdrawn but this has made no substantial change in the position of the Indian rupee, for it continues to be maintained on a *sterling* basis under the existing law. Section 4 of the Currency Act of 1927 has become practically a dead letter as the higher bazaar price of gold makes it unprofitable for the public to offer gold to Government at a price of Rs. 21-3-10 per tola, while Section 5 of the same Act can cause no embarrassment since under it Government have the option to sell at fixed rates *either gold* at the Bombay mint or *sterling* in London.[1] At present the Indian currency system is thus, for all practical purposes, a sterling-exchange standard.

[1] See pp. 45-6.

CHAPTER II

THE THEORY OF MONEY

1. As shown in the preceding chapter, the value of the rupee under 'free mints' was natural and not artificial, determined by the market value of silver and not by the compelling power of law. No human authority could give the rupee a value higher than that of its silver contents so long as the mints were open to the free coinage of silver. If the gold price of silver declined, so did the gold value of the rupee. Owing to various reasons which have been examined elsewhere,[1] Government considered this state of things very undesirable, and therefore decided to close the mints in 1893, with a view to divorcing the gold value of the rupee from that of its silver contents. It was hoped that it would be possible by this means to give the rupee an artificial value, higher than its intrinsic value.

Was it in the power of Government to do so? It is not in the power of any Government to fix the exchange value of, say, wheat, cotton, etc. How then was it thought possible for the Indian Government to regulate the gold value of the rupee? Those who believed in this possibility rested their whole case on what was known as the 'quantity theory' of money. If Government could only *limit* the issue of rupees, they would succeed in raising the value of the unit of money, for the value of money, according to this school, depended on its *quantity*. This 'quantity theory' has been one of the most bitterly contested theories in economics. It has been vehemently denied by some economists; it has been emphatically reasserted by others. Often, it has been erroneously stated. It is necessary, therefore, to give

[1] See *Studies in Indian Currency and Exchange*, pp. 1-30.

a brief outline of this theory, as stated by some of its best exponents.

2. In its simplest form, the theory enunciates an almost self-evident proposition. In a community in which almost all things that are produced are bought and sold, in which there is neither much of barter nor much of hoarding, in which *all* the metallic money, gold or silver, passes from hand to hand at every purchase, in which each unit of money circulates only once, credit in any of its shapes being unknown, the *quantity* of metallic money determines the *purchasing power* of the monetary *unit,* if the total volume of exchange-work or the volume of business transactions carried on with the aid of money remains the same. If fewer units of money were available, there would be more work for each of them to do ; each of them would have to exchange for a larger volume of other things ; the purchasing power of each would be greater than before. If more units of money were available, each would have to exchange for a smaller volume of other things ; its value or purchasing power would be less than before. In other words, if P denotes the purchasing power of the monetary unit, T the volume of exchange-work in the community, and M the number of monetary units, the purchasing power of the unit will be the same as the quantity of work done by one unit ; and so we have the equation $P = \frac{T}{M}$. The value of money, that is its purchasing power, thus *varies inversely* as its quantity. If the quantity of money is increased, the purchasing power of the unit will fall, or, what comes to the same thing, *the price-level will rise ;* and if, on the other hand, the quantity of money is decreased, the purchasing power of money will rise, or, what comes to the same thing, the price-level *will fall exactly in proportion to the increase.*

In the complex world of to-day, however,

conditions are different and we must now make allowance for all the possible influences that go to modify the effect of the quantity of metallic money.

In the first place, metallic coins are not the only media of exchange. Cheques and bank or currency notes serve the same purpose as metallic money and therefore affect prices as well as specie would. The total volume of currency in a country thus includes (1) the quantity of metallic currency in circulation; (2) the amount of bank deposits against which cheques may be drawn; and (3) the number of currency notes in circulation. In the second place, 'the effective currency of the country depends upon the *quickness of circulation* and the number of exchanges performed in a given time, as well as upon its numerical amount; and all the circumstances which have a tendency to quicken or to retard the rate of circulation render the same amount of currency more or less adequate to the wants of trade.'[1] If a coin circulates three times instead of once, it performs the exchange-work which three coins did before. An increase in the rapidity or *velocity* of circulation of currency is thus equivalent to an increase in its quantity.

We must therefore amend our formula $P=\frac{T}{M}$ to the equation $P=\frac{T}{MV+M'V'}$, where M is the quantity of money (including currency notes) in circulation, V its 'efficiency' or 'velocity' of circulation (or the average number of times a year money is exchanged for goods), M′ the total bank deposits subject to transfer by cheque, V′ the velocity of circulation of the latter, and T the volume of trade (or the amount of exchange-work done with money).

As thus stated, the quantity theory does not justify the idea that, if the quantity of metallic money is doubled, prices will *always* be doubled. It may

[1] *Bullion Committee Report* (1810).

be that there is a simultaneous change in all the five influences; the price-level will then be a compound or resultant of these various influences. All that the theory asserts is that, if *other things remain the same,* an increase in the *quantity* of money will increase prices in the *same proportion.*

It is necessary for the reader to bear in mind the many qualifications covered by the economist's favourite phrase 'other things being equal'. The changes in these other things are sometimes more important than the changes in the volume of precious metals. 'There may be a change in the volume of things on sale: there may be an increase or diminution in the average number of times each of these things changes hands during the year, or in the average number of times each coin or each element of the currency changes hands during the year: there may be a change in the methods of business or in the ratio between cash and the demand deposits of the bankers. Thus the phrase "other things being equal" covers so much ground, is so extensive a qualification of the general rule, that one has to recognize the possibility of a great rise of prices without a change in the supplies of gold and silver.'[1]

3. In this form the doctrine is almost a truism, 'for, if one column of a ledger recorded accurately all the transactions for money in a year with their values, while another column specified the number of the units of money employed in each transaction, then the two columns, when added up, would balance. The second column of course would represent the aggregate value of the total number of changes of ownership of all the units of money; and that is the same thing in other words as the total value of the money multiplied by the average changes of ownership (otherwise than by free gift, theft, etc.) of each unit.'[2]

[1] Professor Marshall in his evidence before the Fowler Committee.
[2] Ibid.

But the upholders of the quantity theory believe it to be true in a *causal* sense. They assert that one of the *normal* effects of an increase in the quantity of money is an exactly proportional increase in the general level of prices, for according to them the effect of doubling money in circulation (M) is normally to double deposits, 'because under any given conditions of industry and civilization deposits tend to hold *a fixed or normal ratio* to *money in circulation*. Hence the ultimate effect of a doubling in M is the same as that of doubling both M and M'.' Neither the velocity of circulation, which depends on density of population, commercial customs, rapidity of transport and other technical conditions, nor the value of the country's trade, which depends on natural resources and technical conditions, will be affected in any way by this increase in the quantity of money. So far, therefore, as M *by itself* is concerned, its *normal* effect on the price-level is *strictly proportional.*[1]

It must not be supposed that the believer in this theory of money denies that there are other causes, not included in this equation of exchange, which can and do influence the purchasing power of money. For instance, Professor Fisher, the best exponent of this theory, admits that the five causes are themselves the effects of many antecedent causes, some of which he summarizes as follows :—'The volume of trade will be increased, and therefore the price-level correspondingly decreased by differentiation of human wants ; by diversification of industry ; and by facility of transportation. The velocity of circulation will be increased, and therefore also the price-level increased by improvident habits ; by the use of book credit ; and by rapid transportation. The quantity of money will be increased, and therefore the price-level increased correspondingly by the import or

[1] For qualifications of this doctrine, see Keynes, J. M., *A Tract on Monetary Reform*, pp. 79-83.

minting of money, and antecedently, by the mining of the money metal; by the introduction of another and initially cheaper money metal through bimetallism; and by the issue of bank-notes and other paper money. The quantity of deposits will be increased, and therefore the price-level increased, by extension of the banking system and by the use of book credit. The reverse causes produce, of course, reverse effects.' What the believer in this theory of money asserts is that these are the *five proximate causes through which all others whatsoever must operate.*

Some of the exponents of the theory further maintain that all the factors included in this equation of exchange are not equally important. They contend that, among these, the quantity of specie is, in normal times, the most important, and that the older economists were right in emphasizing its fundamental importance. The rapidity of circulation of goods is fairly constant in a given community. The velocities of circulation of metallic and non-metallic media of exchange, depending as they do on the habits of the individual and the system of payments in the community on the one hand, and on such general causes as density of population and rapidity of transportation on the other hand, change in *normal* times so slowly and to such a small extent as to be almost negligible factors in raising the price-level. The use of precious metals in the arts, though influenced to a certain degree by the value of monetary supply, is in the main influenced by changes in the habits and tastes of people and these are not changed easily, quickly, or appreciably even during several generations. One is therefore justified in saying that, if the total amount of specie is increased, the proportion of it used in making purchases at a given time will be correspondingly increased. Both paper currency and cheques are in *normal* times usually convertible into metal and both have therefore the backing of metallic reserves behind them. The ratio of

metallic reserves to non-metallic media of exchange is not the same everywhere, nor is it unalterable in the same country, since it varies not only with the state of business confidence but also with the changes in the amount of reserve banks generally think it safe to keep. But while this relationship is subject to some variation, it is a very *real* relationship and is more or less a definite one for each well-ordered community in normal times during periods which are not long enough to bring about revolutionary changes in the monetary habits of the people or the banking practices of a country.

Such in brief outline is the modern form of the theory of money, belief in the truth of which inspired the monetary changes of 1893. Their real author, Sir David Barbour, stated in his *Standard of Value* that he was 'firmly convinced of the soundness of the quantity theory of money, and knew that, if the unlimited coinage of silver was stopped, it was quite possible to reduce the amount of the rupee circulation to such an extent as to bring the Indian exchange to a *par* with gold at a rate of exchange which could be permanently maintained'. In the peculiar conditions *then* existing in India, he had considerable justification for the view that the *purchasing power* depended almost *exclusively* on the quantity of rupees in circulation, for the note circulation then was insignificant, and cheques were almost unknown except to a very limited extent in the presidency towns. He assumed, and assumed wrongly, as we shall have occasion to show later on, that a rise in the *internal* purchasing power of the rupee in terms of commodities *would necessarily* bring about a rise in the *external* value of the rupee in terms of the English sovereign or gold. Be that as it may, however, the quantity theory of money on which Sir David Barbour relied neither proves nor disproves this supposed necessary connexion between the *exchange value* of the rupee in terms of *gold* and its

internal *purchasing power* in terms of *commodities*. The quantity theory of money deals with the latter and has nothing to say about the former. The distinction between the two is an important one and the reader must be carefully on guard against the common fallacy of mixing up the two different meanings of the phrase 'the value of the rupee'.

4. At the present time, however, conditions are not so simple as they were in 1893. Since then there has been a great improvement in banking and monetary facilities. Banks serve various purposes; of these, the most important is to create money, or rather, effective substitutes for money. They not only receive as deposits coined money or notes which their customers do not want for the time being, but also *create* deposits in various ways. The borrower who procures a loan from a bank gets it usually not in the form of actual coin or currency notes, but in the form of an entry in the bank's account books, authorizing the borrower to draw cheques to a specified amount, just as if he had deposited that amount. *Thus loans make deposits,* according to the usual phrase; and cheques perform the same functions as coined money or notes. With the increase in banking activity, we are therefore obliged to include in the total quantity of circulating media, cheques, or the amount of deposits against which cheques can be drawn. Leaving out of account the increase in the amount of deposits with the Indian shroffs, for which it is very difficult to get any accurate figures, there has been a phenomenal growth in the amount of deposits with the presidency banks, the exchange banks and the Indian joint stock banks since 1893. The table given overleaf brings out the great contrast between the earlier years and the later period.

The amount of cheques cleared at the clearing houses in the great trade centres tells the same tale, as is shown by the table on page 20.

The increase in note circulation has been still more

surprising. But before dealing with this aspect of the matter, we have to notice in some detail the principles and history of the Indian paper currency system.

Bank deposits on 31 December each year

Year	Presidency banks or the Imperial Bank since 27 January 1921 and branches	Exchange banks		Indian joint stock banks with capital and reserve of five lakhs and over	
	Deposits	Deposits (Indian only)	Number	Deposits	Number
	(Rs. 1,000)			(Rs. 1,000)	
1890	18,35,60	7,53,60	5	2,70,78	5
1900	15,68,80	10,50,35	8	8,07,52	9
1910	36,58,01	24,79,17	11	25,65,85	16
1911	38,58,29	28,16,90	12	25,29,11	18
1912	40,11,48	29,53,62	12	27,25,98	18
1913	42,37,16	31,03,54	12	22,59,19	18
1914	45,65,60	30,14,76	11	17,10,58	17
1915	43,49,86	33,54,56	11	17,87,27	20
1916	49,91,45	38,03,88	10	24,71,05	20
1917	75,43,02	53,37,53	9	31,17,01	18
1918	59,62,03	61,85,60	10	40,59,48	19
1919	75,93,61	74,35,90	11	58,99,47	18
1920	87,04,53	74,80,71	15	71,14,64	25
1921	72,58,00	75,19,61	17	76,89,63	27
1922	71,16,30	73,38,44	18	61,63,86	27
1923	82,76,45	68,44,28	18	44,42,82	26
1924	84,21,48	70,63,48	18	52,50,52	29
1925	83,29,77	70,54,57	18	54,49,36	28
1926	80,35,06	71,54,22	18	59,68,02	28
1927	79,27,45	68,86,23	18	60,84,11	29
1928	79,25,30	71,13,86	18	62,85,36	28
1929	79,24,28	66,65,91	18	62,72,03	33

Year	Total—Calcutta, Bombay and Madras till 1901 and Karachi since 1901 + Rangoon since 1910—Cawnpore since July 1920 + Lahore since April 1921 (in crores of rupees)
1893 ...	1,46
1894 ...	1,58[1]
1895 ...	1,75
1896 ...	1,81
1897 ...	1,90
1898 ...	1,76
1899 ...	2,02
1900 ...	2,12
1901 ...	2,13
1902 ...	2,32
1903 ...	2,47
1904 ...	2,55
1905 ...	3,03
1906 ...	3,35
1907 ...	3,72
1908 ...	3,63
1909 ...	3,68
1910 ...	4,65
1911 ...	5,16
1912 ...	5,87
1913 ...	6,50
1914 ...	5,38
1915 ...	5,63
1916 ...	8,09
1917 ...	9,01
1918 ...	14,32[2]
1919 ...	20,91
1920 ...	29,76
1921 ...	20,25
1922 ...	20,60
1923 ...	18,03
1924 ...	18,06
1925 ...	16,88
1926 ...	16,09
1927 ...	16,74
1928 ...	19,81
1929 ...	19,99
1930 ...	17,31
1931 ...	15,13

[1] These figures are for the calendar year ending 31 December. See *Statistical Tables Relating to Banks in India*, table 16.

[2] These figures are for the financial year ending 31 March. See *Report of the Controller of Currency* (1930-1), statement 20.

CHAPTER III

THE INDIAN PAPER CURRENCY SYSTEM

1. The history of the Indian paper currency system falls into three distinct periods. The dividing point between the first and the second period is the year 1861, and that between the second and the third, the year 1919. Prior to 1861 note-issue was not a Government function ; it was an affair of certain private banks. During the second period, 1861-1919, Government took over the function of issuing notes, and modelled the Indian paper currency system on what are known as the principles of the English Bank Charter Act of 1844. In the period since 1919, various modifications have been introduced into the system with a view to remedying what have appeared to be its defects in the light of the experience of other countries.

2. The first period may be dismissed in a few words. There was then no Government issue of currency notes ; only a few private banks issued them. The circulation of these notes was practically confined to the cities of Calcutta, Bombay and Madras and they were not legal tender in any other part of the country. The three presidency banks were the most important of these note-issuing banks and their maximum authorized issue was only five crores of rupees, against which one-fourth was to be held in specie.

3. The second period opens with Act XIX of 1861, which deprived all private banks of their right of note-issue and based the Indian paper currency system avowedly on the principles of the English Bank Charter Act of 1844. It established a Government monopoly of note-issue, and created a

Paper Currency Department through which Government were to issue notes of various denominations in the form of promissory notes payable to bearer on demand. It divided India into certain circles, each containing one city to be the place of issue of the notes of that circle. It empowered Government to issue notes without limit at any paper currency office against rupees or gold. Until 1910 these notes were legal tender only within the circle of issue and could be encashed as of right only at the head office of that circle. It placed a limit of four crores on the fiduciary issue (or the amount of notes issued against securities) and imposed on Government a legal obligation to keep a metallic reserve in silver coin or bullion against *the whole* of the notes issued beyond that amount. It was dominated by the idea that 'the sound principle for regulating the issue of paper circulation is that which was enforced on the Bank of England by the Act of 1844, that is that the amount of notes issued on Government securities should be maintained at a fixed sum, within the limit of the smallest amount which experience has proved to be necessary for the monetary transactions of the country, and that any further amount of notes should be issued in coin or bullion, and should vary with the amount of the reserve of specie in the bank, according to the wants and demands of the public'. (Government of India Dispatch, dated 26 March 1860, para. 13.)

The object of these provisions was to prevent the issue of notes in excess of public requirements; an over-issue of currency was regarded as a serious evil. It caused prices to rise, and inflicted unmerited injury on people with fixed incomes who found the purchasing power of their money much less than before. The only way to prevent this evil was to make the notes *convertible* into metal and to insist on providing adequate metallic reserves behind them. So long as the note-issuing authorities had to

provide large amounts of specie in reserve, they had very little temptation to over-issue notes. Even if they did, the public was likely to present them back for encashment and so curtail their circulation in excess of public requirements. The authors of the Bank Charter Act, however, went much further than this. They aimed at *ideal safety*. They provided not only for *convertibility* of paper currency but also for its almost *absolute identity with the metallic circulation which it displaced*. In other words, all paper issues beyond a fixed sum were, under their system, to represent actual coin or bullion in the reserve. The Indian Act of 1861 was based on the same ideas; it too made the notes practically bullion certificates, for the rupee then was a freely minted coin worth no more than its silver contents.

The system, however, was not free from *defects*. The limitation of the *areas* of legal tender and of the offices where the notes were encashable on demand restricted the growth in the popularity of notes. Government gained nothing by the issue of notes as the currency offices had to keep in reserve an equivalent amount in coin or bullion; and so notes were *no more economical* than rupees. And during these times when, owing to the briskness of trade, the business community needed more currency, Government's *power to expand* the note-issue was no greater than their power to mint more rupees. The system, in short, lacked one of the essential requirements of a good currency system, namely *elasticity*. It provided for absolute security for encashment of notes; but that almost ideal and, to a large extent, unnecessary safety was more than counterbalanced by the disadvantages from inelasticity and want of economy. The English system which it sought to imitate escaped the inconvenience from inelasticity by the development of the cheque system in English banking, which provided the business community in England with an ideal elastic currency, expanding and

contracting in circulation automatically with the requirements of the situation. Foreign countries met their needs by trying all kinds of new principles for the regulation of their note-issue, attempting all sorts of compromises or half-way houses between absolute security and ideal elasticity. *India* had neither an elastic note-issue nor an elastic cheque currency. She had only *an inelastic note-issue.*

The truth of the matter was that the Indian administrators had copied the English system without taking sufficient account of the difference between the conditions in England and in India. And England, as Professor Marshall pointed out in his cross-examination by the Fowler Committee, was a particularly bad example for India to follow in matters of currency, 'for, firstly, currency is but a small part of the means of payment used in England; and under most, though not all, conditions, bank money is the main means of payment; and that is elastic. Secondly, an imperative demand for increased currency is rare in England; and when it does occur, it is on a very small scale relatively to England's total business and resources..... Thirdly, England is near to other great gold markets. Fourthly, her financial houses are numerous and able..... England's banking system is very highly organized, especially by the aid of the branch banks..... Partly for this reason, currency drawn from London in the spring or autumn completes its circuit more quickly than in Germany; and of course much more quickly than in India.' [1]

4. The closing of the mints in 1893 led indirectly to *some relaxation of this rigidity* of the Indian paper currency system. The rupee became an artificially valued coin, worth more than the silver it contained, by the year 1898; but under the terms of the law governing the Indian paper currency system, it continued to be a legitimate form of the Indian

[1] *Fowler Committee Report,* Minutes of Evidence, Q. 11776.

Paper Currency Reserve. A ten-rupee note could thus be issued by buying silver worth even less than six rupees, coining it into ten rupees, and keeping the latter in the Paper Currency Reserve as the necessary metallic basis under the law. The system thus acquired through inadvertence a certain degree of elasticity and economy owing to a change in the character of the rupee.

5. Various other minor changes in the system established in 1861 were brought about by successive enactments during the period 1861-1913.

(1) In the first place, the amount to be invested, or the fiduciary portion of the note-issue, was increased from time to time, to six crores in 1871, eight in 1890, ten in 1896, twelve in 1905 (of which two crores might be securities of the United Kingdom), and to fourteen in 1911 (of which four crores might be securities of the United Kingdom), so that the composition of the Indian Paper Currency Reserve on 31 March 1913 was as shown below.

Total circulation	Silver in India	Gold in India	Gold in London	Securities	
				Sterling	Rupee
68·97 crores ...	16·45	29·37	9·15	4	10

In spite, however, of this increase in the amount of the invested portion, the *securities in 1913 constituted a much lower percentage of the whole reserve* than in the preceding years owing to the much larger growth in circulation, the figures at the end of the year in which the successive additions to the securities were made being :—1871-2, 44.9 per cent; 1890-1, 27.2 per cent; 1896-7, 42.1 per cent; 1905, 26.9 per cent; 1911-2, 22.8 per cent.

(2) Up to 1893, the whole of the Paper Currency Reserve was held in silver coin but in that year the

executive was authorized by law to issue notes in exchange for gold coin or bullion to any amount. In 1898, Government kept a portion of this *gold in London* under temporary authority. This became a part of a permanent policy under Acts IX of 1902 and III of 1905, which permitted Government to hold the reserve in rupees, gold coin, bullion, or securities either in India or in London, subject only to the exception that *all coined rupees were to be kept in India* and not in London. The primary object of the reserve was to ensure the encashment of notes into rupees and the only justification at first for transferring part of the reserve to London was to *provide means for purchasing* silver to be minted into rupees for the Paper Currency Reserve in India. But experience soon showed that this part of the reserve which was transferred to London could in times of depression *serve as a part* of the general reserves in the hands of the India Office for the support of exchange and Government therefore followed a deliberate policy of increasing steadily *the gold* portion of the Paper Currency Reserve which alone could serve this purpose in case of need. This was *a material change in the object* of the Paper Currency Reserve.

(3) Thirdly, from 1903 onwards, Government pursued steadily the policy of universalizing notes of small denominations with a view to enhancing their popularity. By 1910, notes of small denominations up to and including those for 100 rupees became *universal legal tender* throughout India and encashable as of right at the head office of the *seven* circles. This had a very great effect *on the volume of circulation* as can readily be seen from the table given overleaf taken from the report of the Chamberlain Commission.

6. Such was the state of affairs when the Chamberlain Commission made a searching examination of the whole system. The Commission in their

Average of year	Gross circulation, that is the value of all notes issued and not paid off	Net circulation, that is gross circulation less the value of notes held by Government in their treasuries	Active circulation, that is the net circulation less the value of notes held by presidency banks and their head offices
	(crores of rupees)		
1900-1 ...	28·88	26·54	22·05
1906-7 ...	45·14	41·48	33·93
1911-2 ...	57·37	51·83	41·89
1912-3 ...	65·62	54·92	45·39

final report made a number of valuable suggestions. They declared themselves in favour of the immediate universalization of the 500-rupee note, and of increasing the facilities for the encashment of notes. They advocated, further, a radical departure from the general principles of the English Bank Charter Act of 1844, on which the Indian paper currency system had so far been regulated. They recommended that the fiduciary portion of the note-issue should be increased from fourteen crores to twenty crores, and thereafter fixed at a maximum of the amount of notes held by Government in the reserve treasuries *plus one-third of the net circulation*, and suggested that Government should take power to make *temporary* investments or loans from the fiduciary portion within this maximum in India and in London, as an alternative to investment in permanent securities.

The Commission expected the following advantages from the policy they recommended:—

'(1) While the permanent addition to the invested portion of the reserve will be no more than is justified by past practice and experience, without in any way endangering the complete convertibility of the

notes, the revenues of India will secure the profit earned by investing the amount now held idle in the form of gold in India. (2) There will be occasions, especially in the busy season, when it will be safe to lend temporarily sums which it would be unwise to invest permanently. The power to make such loans will, therefore, enable the Government to earn interest on sums which would otherwise be idle needlessly, and will provide at the same time a much needed facility for a temporary expansion of the currency in the busy season, by virtue of which the market may obtain some relief, though not at first, perhaps, a very great amount, from its recurrent stringency. (3) The power to make temporary investments in London on account of the Paper Currency Reserve, will be a convenience to the Secretary of State in permitting him to sell Council Drafts against the Paper Currency Reserve, in anticipation of silver purchases or of any other cause, without the loss of interest and other disadvantages which might sometimes come about if he were compelled, without discretionary power, to utilize the entire proceeds of such sales in earmarking gold. (4) As the circulation of notes in India increases, it will be within the power of the authorities to increase, as and when desirable, either the permanent or the temporary investments of the reserve or both without a special Act. (5) The power to make loans from the cash held against notes in the reserve treasuries will provide the Government with a useful alternative or supplementary means of counteracting some of the disadvantages arising from the existing reserve treasury system.'

7. This report, however, was stillborn. Its recommendations were still under the consideration of the Government of India when the War broke out. It was therefore decided to postpone further action on the report until the return of normal conditions. Meanwhile, the War subjected the Indian paper

currency system to a severe strain and important developments took place in it.

(1) *The legal limit of the invested portion* of the Paper Currency Reserve which, prior to the War, stood at 14 crores was, between 1915 and 1919, raised nine times till at the end of 1919 it stood at 120 crores, of which 20 crores could be invested in securities of the Government of India. This made it possible to issue large quantities of paper money *without any metallic backing* behind them. During this period the gross circulation of notes increased nearly threefold while the percentage of the metallic backing decreased by nearly half as is shown by the following table.

Date	Gross note circulation (in lakhs of rupees)	Percentage of the metallic reserve to gross note circulation
31 March 1914 ...	66,12	78·9
,, 1915 ...	61,63	77·3
,, 1916 ...	67,73	70·5
,, 1917 ...	86,38	43·9
,, 1918 ...	99,79	38·4
,, 1919 ...	153,46	35·4

(2) The use of paper currency was further encouraged by the issue, in December 1917 and January 1918, of notes of Rs. 2-8 and Re. 1 respectively. In 1918-9, owing to the high price of silver, Government curtailed the supply of rupees, and forced the public to fall back upon paper currency even for small transactions. The result was that in the year 1918-9, the circulation of 1-rupee notes increased from Rs. 33 lakhs to Rs. 1051 lakhs, and that of 2½-rupee notes from Rs. 18 lakhs to Rs. 166 lakhs.

(3) The force of circumstances obliged Government to drift on to a policy of making the notes *de facto* inconvertible. Owing to a steady fall in the percentage of metallic backing, Government withdrew in 1916 the pre-War facilities for encashing notes at the district treasuries. But in spite of this restriction the situation grew rapidly worse. In April 1918, the silver balances of Government fell to under 10½ crores, that is about 8 crores less than what was regarded as a safe minimum before the War. The unfavourable War news in March and April 1918 produced a run on the Bombay Currency Office, and it seemed almost certain that Government would be forced to declare the notes to be legally inconvertible. But this contingency was avoided by the timely announcement of the purchase of a large amount of silver from the Government of the United States. The impending crisis, however, showed the wisdom of conserving, as far as possible, India's metallic resources, if future trouble was to be avoided. With a view to this end, Government *prohibited the booking of specie by rail and steamer* and 'limited the daily issue of rupees to single tenderers of notes to a figure which made it practicable to satisfy large demands in part and small demands as a rule in full'. These restrictions resulted at first in a considerable *discount* on notes in many parts of India, especially on the new 2½-rupee and 1-rupee notes but 'the discount rapidly diminished when it was seen that the notes were freely accepted in payment of Government dues, and when small coin was made available in large quantities'.

(4) A new feature was introduced in the Paper Currency Reserve in the year 1916-7. Owing to the rise in the rate of interest, the market value of the old 2½ per cent British securities had declined enormously, and, with a view to replacing them gradually by more suitable securities, it was decided to create a Paper Currency Reserve Depreciation

Fund out of the interest received on paper currency investments.

8. These changes, along with other effects of the War on the Indian exchange and currency system, were the subject-matter of consideration by the Babington Smith Committee appointed on 30 May 1919. The Committee submitted their report on 22 December 1919, and made the following recommendations in connexion with the Paper Currency Reserve :—[1]

'(1) The statutory minimum for the metallic portion of the Paper Currency Reserve should be *forty per cent* of the gross circulation. As regards the *fiduciary* portion of the reserve, the holding of securities issued by the Government of India should be limited to twenty crores. The balance should be held in securities of other Governments comprised within the British Empire, and of the amount so held not more than ten crores should have more than one year's maturity, and all should be redeemable at a fixed date. The balance of the invested portion above these thirty crores should be held in short-dated securities with not more than one year's maturity, issued by Governments within the British Empire. The existing permissive maximum of 120 crores should be retained for a limited period. The sterling investments and the gold in the Paper Currency Reserve should be revalued at two shillings to the rupee.

'(2) With a view to meeting the seasonal demand for additional currency, provision should be made for the issue of notes up to five crores *over and above* the normal fiduciary issue as loans to *the presidency banks* on the security of *export* bills of exchange.

'(3) The silver and gold in the Paper Currency Reserve should be held *in India* except for *transitory purposes*.

'(4) As soon as circumstances permit, free facilities

[1] *Babington Smith Committee Report.*

for *the encashment* of notes should be given, and the restrictions imposed during the War should be withdrawn. The Government should have the option of redeeming their notes in full legal tender gold or silver coin.'

It is easy to see that recommendations (1) and (2) implied a radical change in the principles of the pre-War Indian paper currency system. If the pre-War system was too inelastic and rigid, the pendulum now seems to have swung in the opposite direction, and elasticity was sought to such an extent as almost to jeopardize the safety of the system. The recommendations of this Committee in favour of elasticity went much further than those of the Chamberlain Commission. The authors of the report admit that under the recommendations of the Chamberlain Commission it would have been necessary to provide at the time of the report a metallic reserve to the amount of 119 crores as compared with only 80 crores or so held at that time. But it was contended that so large a reserve was not required for ensuring the convertibility of the note-issue (*see* para. 78). It should not be forgotten that currency notes in India were legally convertible into rupees only, and that the latter contained silver worth much less than their official or legal value. So that if coins were converted into bullion, a 40 per cent metallic reserve in coin was hardly equal in normal times to a 30 per cent metallic reserve in terms of silver bullion. Add to this the further recommendations that, when permanent legislation was introduced in replacement of the temporary provisions then existing, authority for retaining for a limited period the existing permissive maximum of 120 crores for the fiduciary issue should be sought (though in the pre-War period the invested portion of the Paper Currency Reserve was limited only to 14 crores), and that, in addition to this amount Government were to be authorized to issue notes up to 5 crores on

the security of commercial bills of exchange without any metallic backing whatsoever, and one can easily realize what a long way the Indian Paper Currency system was being moved from that ideal safety aimed at by the principles of the Bank Charter Act on which the pre-War Indian paper currency had been regulated. It was admitted by official experts like Mr. Howard that 'we have unfortunately been compelled by the force of circumstances during the War to go very considerably further than the Chamberlain Commission recommended, or than prudence would have dictated if events had not been too strong for us'. It was recognized in theory by the Committee that there was a 'special need for caution in dealing with the note-issue in such a country as India, where a large part of the population is illiterate and the extended use of paper currency is a habit of very recent growth' but these recommendations, which were in reality so much at variance with this excellent maxim, were made under the specious plea that it was essential to introduce elasticity into the system. Nobody denied the need of some elasticity; the point at issue was the extent to which elasticity was to be pursued consistently with safety. No case was made out for going much further than the Chamberlain Commission recommended; and no heed was paid to the contention of the only Indian member that even eighty per cent would not be too high a figure to fix as a normal proportion of metallic reserve to the total of notes outstanding (see para. 27 of Mr. Dalal's dissenting minute).

It is necessary in this connexion to bear in mind the peculiar conditions of India so forcibly pointed out by Sir Vithaldas Thakersey in the following extract from his evidence before the Babington Smith Committee :—

'Q. 5787. If you had a note-issue of 200 crores, you would hold 150 crores in metal?—Yes, at least.

'Q. 5788. Is that not a very large proportion

compared with the amount found necessary in most countries which have a paper currency?—Yes, I have been now all over the world; I have been in China, Japan and America, and have been watching the movement of silver. In India metallic currency is largely used and therefore it is necessary to hold a larger reserve. In Japan, I did not ordinarily see a metal coin; even the ten and twenty cents are in paper. The reason is that the people have been educated. They can all read. On the other hand, people in India are poor; they are uneducated. They know the value of the metal, but they do not know the value of paper. Then, during the monsoon, paper is worthless to them. They carry their money in their dhotis and they get wet; currency notes get dilapidated, torn or lost, and they burn in a fire. All these difficulties are peculiar to India.'

It must be admitted, however, in fairness to the Babington Smith Committee that their recommendations sought to effect an improvement in the conditions existing in 1917 and 1918 or those permissible under the law in 1919. During the period of the War, Government had expanded the fiduciary note-issue to an enormous extent. As Mr. Dalal put it, 'it was no longer a case of investing a portion of the metallic reserve held in India against outstanding notes; notes were boldly issued, against which no metallic reserves in India had ever existed. Also the proportion of the metallic reserves to the total of outstanding notes was not allowed to have any weight. It was a case of simply watering the note-issue in its worst form—issuing notes without any metallic backing. In other words, it was a forced loan from the Indian public, free of interest.' The recommendations of the Committee were certainly an improvement on the state of affairs in 1918 and 1919 (see the table on page 29). The operation of these recommendations is illustrated by the Committee by means of the following figures, exhibiting the

composition of the reserve, (*a*) as it stood on 30 November 1919, (*b*) as it would stand if the invested portion was at the maximum permitted under the then existing law, and consequently if the metallic reserve was at the minimum possible, and (*c*) as it would stand if the metallic reserve was the minimum permitted under their recommendations.

	Gross note circulation	Silver	Gold	Securities		Percentage of total metallic reserve to gross note circulation
				Indian	British	
			(lakhs)			
Actual figures for 30 November 1919	179,67	47,44	32,70	17,03	82,50	44·6
Figures showing the maximum fiduciary issue under the then existing law	179,67	59,00	67	20,00	100,00	33·2
Figures showing the maximum fiduciary issue under the Committee's proposals	179,67	71,00	87	20,00	87,80	40

A word may here be said in justification of the limits imposed by the Committee on the various forms of investment in the Paper Currency Reserve. The experience of the War had shown the worthlessness of all long-dated securities in times of stress; even British consols, which in pre-War days were regarded as readily saleable securities in all circumstances, were found to be practically unrealizable in times of grave crisis. The rupee securities in particular were likely to be unmarketable at the very time when it would be necessary to turn them into

cash. There would be a run on the currency offices only when there was loss of confidence in Government. At such times the rupee securities too would be valueless. It was unwise on the part of a Government that expected to raise frequent loans in the market to rely, in a crisis, on their ability to turn into cash the additional securities created for issue to their Paper Currency Reserve. The second recommendation of the Committee was intended to provide adequately for the seasonal fluctuations in the demand for currency, and was suggested by the Federal Reserve Board system in America. The only way in which, under the pre-War system, currency could expand in India in the busy season was by the issue of rupees or notes in India against either the tender of gold in India or sterling in London. Both these courses meant an import of funds from abroad. Internally there was no device for expanding the currency to satisfy the demands of trade in the busy season. The result was that discount rates soared high during this period of financial stringency. During the same months the active circulation of notes was usually at its highest and the call on the Paper Currency Reserve at its lowest point. With a view to curing this defect, several witnesses before the Committee suggested a more elastic provision for the discounting of commercial bills out of the funds provided in the Paper Currency Reserve. The arguments in favour of this course were summed up by Mr. Howard as follows :—'Very briefly, circulation due to discounts of this kind is automatically regulated by the demand for currency and entirely eliminates any danger of permanent inflation. The security is absolutely good, and the arrangement is based on the fact that, as *The Times* puts the position, "a self-liquidating bill has a self-retiring note as its concomitant." This would be particularly the case in India where the seasonal fluctuations occurring within very brief periods are so violent;

and the existence of this facility might of itself tend to do a great deal to level down the bank rate, even though it was not at first taken very extensive advantage of.'

9. These recommendations of the Committee were in the main incorporated in the Paper Currency Act of 1920 and the Consolidating Act of 1923. The main change of importance was in the minimum percentage of the metallic portion of the reserve, which was fixed at 50 per cent instead of 40 per cent of the gross circulation. As recommended by the Committee, gold bullion in the Paper Currency Reserve was reckoned at the rate of one rupee for 11.30016 grains troy of fine gold, and silver bullion at the price in rupees at which it was purchased. Similarly, for the purpose of determining the value of the securities reserve, purchased securities were to be valued at the price at which they were purchased (two shillings being reckoned as equivalent to one rupee in the case of sterling securities), and *created* securities at the market price of similar securities on the date of their issue. The maximum amount of Government of India securities in the fiduciary portion of the reserve was fixed at 20 crores, of which not more than 12 crores were to be securities *created* by the Government of India and issued to the Controller of Currency.

It was recognized from the very outset that these 'permanent provisions' could not be enforced in the near future. During the interval between the passing of this Act and the date on which these permanent provisions could come into operation, the constitution of the reserve was, therefore, to be governed by certain temporary provisions under which the securities of the Government of India held in the reserve were limited to 85 crores *without any restrictions as to the amount of Indian securities*, and so long as the 'created securities' exceeded 12 crores, all interest derived from the securities

in the Paper Currency Reserve was with effect from 1 April 1921 to be applied in reduction of such excess holdings.

Further, the Act empowered the Governor-General in Council to issue currency notes up to 5 crores in value against bills of exchange maturing within ninety days from their date of issue and under conditions to be prescribed by the Governor-General in Council. No advantage was taken of this provision in 1920-1, and detailed regulations on the subject were not issued till 16 February 1922. Under these regulations, the seasonal expansion of note-issue up to 5 crores was to take place, not against the export and import bills as recommended by the Babington Smith Committee, but against *internal* bills or hundis drawn for *trade* purposes. In case the documents themselves did not bear any evidence of being drawn for such purposes, the Imperial Bank was to certify that to the best of its knowledge, the accommodation provided for was for the furtherance of trade. In order to restrict the issue of seasonal currency to cases of proved and actual stringency, the regulations laid down that loans of this kind should not be granted at a lower rate than eight per cent.

Another important change in the paper currency system was made in 1924. On 11 February 1924, the Finance Member announced in the Legislative Assembly that the Government of India had decided to place no further orders for 1-rupee notes and that the issue of 1-rupee and 2½-rupee notes even in small amounts would definitely cease from 1 January 1926.

10. The experience of the first two years' working of this system proved the inadequacy of the provision for seasonal expansion of currency. The Act was accordingly amended during 1923-4, raising the maximum limit of seasonal issue from 5 to 12 crores. The regulations on the subject

were also modified so as to provide that loans should be admissible as soon as the bank rate rose to six per cent and that the entire amount of loans outstanding at any time should bear interest at current bank rate subject to the following minimum rates :— 6 per cent for the first 4 crores ; 7 per cent for the second 4 crores ; and 8 per cent for the third 4 crores. Even these measures proved insufficient to relieve the monetary stringency in the busy season of 1923-4 and early in September 1924, the Government of India announced further changes in the rules under which loans were made to the Imperial Bank from currency so as to make it possible for the bank to borrow 4 crores when the bank rate was at 6 per cent, and 8 crores when the bank rate was at 7 per cent instead of 4 crores at each rate from 6 to 8 per cent. Further, in February 1925 the Indian Paper Currency Act was amended so as to increase the permissible limit of the holding of securities in the reserve from 85 to 100 crores, provided that the total amount of created securities of the Government of India should not exceed 50 crores.

The permanent provisions of the Acts of 1920 and 1923 regarding the constitution of the security portion of the Currency Reserve have not yet been given full effect to. On 31 March 1921, the Government of India securities in the Paper Currency Reserve amounted to 68.07 crores, of which 61.26 crores were created securities. Under the Act, the total amount of these was to be reduced to 20 crores of securities, of which not more than 12 crores were to be created securities. In 1920 the Finance Member announced that Government would set aside every year the whole of the interest on securities in the Paper Currency Reserve, 'the profits on our rupee coinage when such again arise', and the interest on the Gold Standard Reserve 'when it exceeds forty million pounds', towards extinguishing these created securities. As a matter of fact nothing of the sort has

been done. There has been no fresh coinage of rupees, the profits on which could be utilized for this purpose. The income from paper currency securities has been appropriated to general revenues on one pretext or another; so also the interest on the securities in the Gold Standard Reserve except during the years 1921-2 and 1922-3.

The table given below shows at a glance the composition of the Paper Currency Reserve since 1920.

11. In 1926 the Indian paper currency system came once again under the searching examination of

Date	Gross circulation of notes	Active circulation, that is gross circulation minus currency notes in Government treasuries, and notes held by the Imperial Bank at head offices
	(lakhs)	
31 March 1920	174,52	153,78
,, ,, 1921	166,16	147,88
,, ,, 1922	174,76	157,23
,, ,, 1923	174,70	161,10
,, ,, 1924	185,85	169,06
,, ,, 1925	184,19	166,55
,, ,, 1926	193,34	167,71
,, ,, 1927	184,13	164,31
,, ,, 1928	184,87	174,53
,, ,, 1929	188,03	178,19
,, ,, 1930	177,23	159,52
,, ,, 1931	160,84	148,10
22 Sept. 1931	146,22	not available
15 Dec. 1931	170,86	

(a) Includes 61,26 Indian treasury bills.
(a¹) ,, 57,89 ,, ,, ,,
(a²) ,, 49,65 ,, ,, ,,
(b) Valued at Rs. 10 per £1 or Re. 1 for 11.30016 grains fine gold
(c) Under Section 20 of Act X of 1923.

a Royal Commission. The recommendations of this Commission involved far-reaching changes. Note-issue was to cease to be a function of Government; it was to be made over to a new reserve bank, modelled on the lines of a central bank in other countries. The 'issue department' of this bank was to be separated and kept wholly distinct from its 'banking department' in which its general banking business would be carried on.[1] Instead of the fixed fiduciary issue system, the Commission recommended the adoption of a *proportional* reserve system with a view to making the note-issue more elastic. Both

Coin and Bullion				Internal bills of exchange held on account of Government (c)	Securities	
Silver coin in India	Gold coin and bullion in India (b)	Silver bullion in India	Gold coin and bullion in transit		Held in India	Held in England (b)
			(lakhs)			
32,22	44,37	6,63	3,45	...	19,59	67,27
61,42	24,17	4,14	...	...	68,07*a*	8,34
72,96	24,32	4,56	...	...	65,08*a*[1]	5,85
82,50	24,32	4,56	...	...	57,48*a*[2]	5,85
74,18	22,32	5,82	...	12,00	57,53*a*[3]	1,40
70,02	22,32	6,73	...	8,00	57,12*a*[4]	19,96
77,25	22,32	7,66	...	...	57,11*a*[5]	29,00
95,94	22,32	8,53	...	2,00	49,77	5,57
98,72	29,76	7,66	...	7,00	37,96	3,77
94,94	32,22	4,95	...	2,00	43,23	10,69
108,11	32,27	2,85	...	...	33,85	15
117,86	25,85	6,94	...	...	10,19	...
126,68	4,48	5,85	...	...	9,19	...
118,48	4,56	7,99	...	...	39,82	...

(*a*[3]) Includes 49,65 Indian treasury bills.
(*a*[4]) ,, 47,12 ,, ,, ,,
(*a*[5]) ,, 47,12 ,, ,, ,,
up to 31 March 1927, and at Rs. 13⅓ per £1 since 1 April 1927.

[1] *Hilton Young Commission Report*, para. 143.

notes and rupees were to be convertible into gold bars in quantities of not less than a specified minimum not for export only, but for any purpose.[1] With a view to ensuring this convertibility, the bank would be bound by statute to keep in its reserve gold and gold securities to the extent of not less than 40 per cent of the notes in issue plus 50 crores on account of outstanding rupees[2] subject to a possible temporary reduction with the consent of Government on payment of a tax.[3] In other words, an addition of 40 units to the gold reserve would normally permit the bank to issue notes to the amount of 100 units; and conversely, a loss of reserve of 40 units would force it to contract notes in circulation to the extent of 100 units. The new proportional system would thus permit of a far wider range of expansion and contraction than the pre-War system of paper currency in India based upon the principles of the Bank Charter Act of 1844.[4]

The character of the new bank-notes would differ from the existing currency notes in another very important respect. No legal obligation for conversion into silver rupees should attach to them, though the bank would be bound to give gold bars in exchange for them for all purposes and to convert all notes, other than one-rupee notes, on demand into legal tender money, that is into notes of smaller denominations or silver rupees at its option.[5] The effect of this would be that the Indian currency system would not be at the mercy of the price of silver, however high it might rise. Moreover, this would dispense with the necessity of keeping in the Currency Reserve for the purpose of internal convertibility, a large stock of silver which for external purposes was of little value.[6]

The Commission further recommended that the

[1] *Hilton Young Commission Report*, paras. 59, 60.
[2] Ibid., paras. 131-2. [3] Ibid., para. 153. [4] Ibid., paras. 125-30.
[5] Ibid., para. 72. [6] Ibid., paras. 67-71.

currency authorities should, concurrently with the first issue of notes of the new status, reintroduce one-rupee notes which should be full legal tender and which, like other notes of the new status, should not be convertible by law into silver rupees.[1]

As regards the proportions and composition of the Currency Reserve, the Commission recommended that various constituents of the gold and gold securities should form not less than 40 per cent of the reserve and that an effort should be made to work up to a reserve ratio of 50 to 60 per cent. The gold holding should be raised up to 20 per cent of the reserve as soon as possible and to 25 per cent within ten years, and be held in India to the extent of at least one-half.[2] The silver holding in the reserve was, on the other hand, to be gradually reduced, during a transitional period of ten years, from 85 crores to 25 crores, on the basis of the existing circulation.[3] The balance of the reserve was to be held in the Government of India rupee securities and self-liquidating trade bills, the former being limited to 25 per cent of the reserve, or 50 crores, whichever was less.[4]

The Government of India accepted these recommendations almost in their entirety, and two Bills incorporating them were introduced in the Indian Legislature in the spring session of 1927. The first of these known as Act No. IV of 1927 received the assent of the Governor-General on 26 March 1927, and amended the Indian Coinage Act of 1906 and the Indian Paper Currency Act of 1923 in two important particulars. It removed the legal tender quality of British sovereigns and half-sovereigns. It fixed the gold value of rupees and notes at the rate of 8.47512 instead of 11.30016 grains troy for one rupee. Further, it imposed new obligations on

[1] *Hilton Young Commission Report*, para. 72.
[2] Ibid., para. 78.
[3] Ibid., para. 80.
[4] Ibid., para. 81.

the Government with regard to the purchase and sale of gold in India. Under Section 4 of the Act, Government were bound by law to *buy* gold at a price of Rs. 21-3-10 per tola of fine gold in the form of bars containing not less than 40 tolas, while Section 5 laid an obligation on Government to *sell* for legal tender currency *gold* for delivery at the Bombay mint or, *at the option of Government, sterling at* the same price after allowing for the normal cost of transport from Bombay to London, provided that no person should be entitled to demand an amount of gold or sterling of less value than that of 1,065 tolas (400 ozs.) of fine gold.

The second Bill, which incorporated the other recommendations of the Commission regarding the note-issue and the creation of a Reserve Bank of India to control credit, currency and exchange, was debated in two sessions of the Assembly, but was eventually withdrawn owing to acute differences over the constitution of the proposed reserve bank. Further reform of the paper currency system was thus postponed *sine die*.

12. Let us now recapitulate briefly the salient features of the Indian paper currency system as it existed on 20 September 1931.

(1) The function of note-issue was still dissociated from banking in India and was retained by Government, but the agency of the Imperial Bank was utilized for the purpose of issuing emergency currency against bills of exchange in the busy season.

(2) Government were under a legal obligation to issue currency notes of various denominations in exchange for an equivalent amount in rupees or half-rupees, or gold in the form of bars containing not less than 40 tolas of fine gold at the rate of one rupee for 8.47512 grains troy of fine gold.

(3) Indian currency notes were under the law convertible into rupees as well as into gold bullion in India or, at the option of Government, sterling in

London at fixed rates, subject to the proviso that no person was entitled to demand an amount of gold or sterling of less value than that of 1,065 tolas of fine gold.

(4) Notes of the denominational value of one rupee, ten rupees, fifty rupees, one hundred rupees, or of any other denominational value which the Governor-General might, by notification in the *Gazette of India,* declare as 'universal currency notes' were legal tender at any place in British India. Any other note was legal tender only within the circle from which it was issued.

(5) The Indian Paper Currency Reserve consisted of two parts, namely (*a*) a metallic reserve and (*b*) the Securities Reserve, which included (i) securities of the Government of India, (ii) securities of the United Kingdom, the date of maturity of which was not more than one year from the date of purchase, and (iii) bills of exchange which would mature within ninety days, of a total value not exceeding 12 crores. Under the permanent provisions of the Acts relating to paper currency, the metallic reserve was to be equal to parts (i) and (ii) of the Securities Reserve, and the holding of Government of India securities in the Securities Reserve was to be limited to 20 crores, of which not more than 12 crores could be created securities. Under the temporary provisions then in operation, the fiduciary portion was limited to 100 crores of which not more than 50 crores were to be created securities.

(6) The existing note-issue was more elastic than the pre-War paper currency in two ways. Firstly, a liberal provision had been made for the issue of temporary emergency currency and secondly, the principle of a proportional system accepted by Government and incorporated in the Acts relating to paper currency served as a guide to Government in their currency policy.

13. In consequence of the suspension of the

gold standard in England on 21 September 1931, severe restrictions were imposed on the sales of *gold* or *sterling* under Section 5 of the Currency Act of 1927 by the Gold and Sterling Sales Regulation Ordinance 1931 and the rules made under it. The sales were to be completed only by the Imperial Bank at its local head offices in Calcutta and Bombay and to be confined to branches in Calcutta or Bombay of certain *recognized* banks. The ordinance prohibited sales for (1) 'financing imports of gold or silver coin or bullion' or (2) 'liquidating the oversold exchange position of any bank in respect of any month subsequent to the month in which the demand for gold or sterling is made', and limited them to the financing of normal trade requirements, of contracts completed before 21 September 1931, and of reasonable personal and domestic purposes. The minimum amount of gold or sterling to be sold to any recognized bank was fixed at £25,000 and the secretary of the Local Board of the Imperial Bank at Calcutta or Bombay was vested with the exclusive power to decide if any demand satisfied the conditions laid down by the said ordinance and the rules made under it. In January 1932 this ordinance was withdrawn but rupees, and along with them rupee notes, continued to be linked to *sterling* instead of *gold* by executive action.

CHAPTER IV

FOREIGN EXCHANGES

1. The changes in 1893 were inspired, as we have already seen, by a belief in the possibility of raising artificially the gold value of the rupee by limiting the quantity of rupees in circulation. But the reason why Government sought to give the rupee some artificial value was the serious inconvenience the free and automatic silver standard was supposed to have caused to various classes of people including Government. The frequent variations in the gold value of silver were accompanied by wide and frequent fluctuations in the external value of the rupee, introducing an element of uncertainty in the commercial and financial transactions between England and India. For instance, the exporter from India was paid by a bill of exchange on London payable in *sterling* by the British consignee, but he himself purchased the produce in the Indian market with *rupees*. Similarly the importer in India paid for his goods in London in sterling but received his selling price in India in terms of rupees. Each had to change sterling into rupees, or rupees into sterling and each found his calculations upset by the fluctuations in the relative values of the two. How wide and frequent the fluctuations were, may be seen by a glance at the following table.

		Rate of exchange	
		s.	*d.*
Average of five years	1860-1 to 1864-5	1—	11·892
,, ,,	1865-6 to 1869-70	1—	11·310
,, ,,	1870-1 to 1874-5	1—	10·576
,, ,,	1875-6 to 1879-80	1—	8·534
,, ,,	1880-1 to 1884-5	1—	7·644

			s. d.
Average of the year 1885-6	...	...	1—6·254
,, ,, 1886-7	...	...	1—5·441
,, ,, 1887-8	...	...	1—5
,, ,, 1888-9	...	...	1—4½
,, ,, 1889-90	...	...	1—4¾
,, ,, 1890-1	...	...	1—6¼
,, ,, 1891-2	...	...	1—4¾
,, ,, 1892-3	...	...	1—3

It was to stop this element of chance and uncertainty that the Government of India embarked upon the monetary revolution of 1893. They aimed at controlling the sterling value of the rupee (or the rupee-sterling exchange as it is technically called), and at fixing it to some constant level so as to reduce these fluctuations to a minimum.

2. What are the natural causes of these variations in exchange which the Government of India sought to control? Why is it that the external value of the currency of one country in terms of that of another country varies at all? The answer to this question lies in what is technically known as the 'theory of foreign exchanges'. But in order to be in a position to grasp this theory, it is necessary to bear in mind a few details about *bills of exchange*—the instruments most commonly employed in the settlement of obligations between different places.

Suppose merchant A at Karachi buys wheat from merchant B at Lahore, and merchant C at Lahore buys cotton cloth from merchant D at Karachi. To simplify matters, let the amount involved in both cases be the same, say Rs. 1,000, and let it be payable in each case three months hence. On account of these transactions, B at Lahore acquires the right to call upon A at Karachi to pay Rs. 1,000 three months hence; and similarly D at Karachi acquires the right to order C at Lahore to pay the same amount by the same time. It is easy to see that if D sells to A his claim on C, and the latter makes it over to B, both B and D can realize

their claims without any money passing from Karachi to Lahore and vice versa. These orders, or bills of exchange as they are called, are thus a *means of transferring debts* from one person to another and merchants anxious to secure the most convenient means of remittance to different places are generally on the look-out for them, with the result that every commercial centre develops a market for bills on other centres. To make a bill of exchange *readily saleable* in the market, it is necessary, however, that it should carry on it some evidence that the party on whom it professes to be drawn will acknowledge his liability to pay it at the due date. In technical language, the drawee or someone on his behalf must sign his 'acceptance' on the bill of exchange to make it 'negotiable'.

A bill of exchange payable *after a time* is obviously not so convenient as *cash* to those who are in need of ready money. Banks and discount houses at this stage come to the help of trade. If a bill of exchange is 'accepted' by a party of some standing, banks will readily 'discount' it or turn it into cash, after deducting a small amount for advancing money before it *matures* and for the risk they run in buying commercial paper. In other words, banks or discounting houses lend money for the interval between the date of discounting and the date of maturity. Further, to accommodate trade, banks and accepting houses often 'accept' bills on behalf of their customers so as to facilitate their discounting in the market. A bill of exchange has therefore to pass through two stages before it is converted into cash—it has to be 'accepted' and 'discounted'.

All these details are described in semi-technical language by Professor Marshall as follows :—'A bill of exchange, is generally a written request by the "drawer" of it, addressed to another, the "drawee", in which he is requested to pay a certain sum of money to a person indicated on the face of

the bill and called the "payee". This person may be the drawer himself or a third person. It may request the drawer to pay it to any one, to whom the payee may transfer the bill, subject to certain conditions and formalities. The bill states the time at which it is payable, as for instance, at sight, or at three months from date. When the bill has been "accepted" by the signature of the drawee written across its face, it then becomes a promissory note from him, its acceptor. For, a payee may sell it to a second person, who may sell it to a third, and so on; each seller signing it on the back, or endorsing it, before he passes it on. The selling value of the bill is reached by deducting a "discount" from the value on the face of it. This discount varies, firstly, with the time for which the bill has yet to run; secondly, with the market rate of discount on short, secure loans; and thirdly, with the risk that it may be difficult, or even impossible, to collect the value of the bill. The demand for payment of it will be made in the first instance on the acceptor of the bill; and failing him, from the drawer; and failing him, from its endorsers in the order in which they have signed their names.'

3. We are now in a position to deal with 'foreign exchanges' or commerce in bills of exchange on foreign countries. Let us take the easiest and the simplest case first—that of exchange between two centres A and B, which have the same gold coin (or paper currency freely convertible into gold) as their legal tender, and which impose no impediment on the free movements of gold—the case represented, for instance, by Sydney and London in pre-War days. At any one time there will be found a number of persons in A who have to make payments to their creditors in B, and a number of others who have to receive money from their debtors in B. One of the ways of remitting money from A to B is to buy in A a bill of exchange on some one in B from those

who are willing to sell such a bill in A. If on the whole A has for any reason to send more money to B than B has to remit to A, the demands for bills on B (say of 100 units payable at sight) will be greater than their supply. The value of each will rise above 100 and exchange will then be said to be *favourable* to B. But no one would ordinarily give for such a bill more than what it would cost to get its gold equivalent and ship it to his creditor for, when there were two ways of remittance open to any one, he would, for obvious reasons, choose the one which cost less. The price of a bill on a first-rate party in B, payable on sight, cannot therefore in ordinary circumstances rise above its face value in bullion by more than the cost of sending bullion. This limit is technically known as the *upper specie point*. If, on the other hand, A has, for any reason whatsoever, to receive more money from B than B has to send to it, the supply of bills of exchange on B (say of the face value of 100 units, payable at sight) will be greater than the demand. The value of each will be lower than 100 and exchange will then be said to be unfavourable to B. But it would not ordinarily go below 100 *minus* the cost of shipping gold coins (or bullion worth as much) from B to A, because in that case it would be cheaper for those who have to get money from B to realize their claims in gold and have it shipped from B to A, rather than sell their bills of exchange on their debtors in B. This limit is known as the *lower specie point*. The market value of such a bill of exchange on B will thus, *in normal circumstances*, fluctuate between the *upper and lower specie points* in accordance with the keenness of demand in A for bills on B.

Circumstances, however, are not always normal. There are times when exchanges sink and rise beyond specie points even in the case under consideration. For instance, the exporters in a country,

at times, labour under the urgent necessity of selling their bills *immediately* at any sacrifice and cannot afford to wait for the arrival of specie.[1] A commercial panic or a stringent money-market may create a reluctance on the part of purchasers to buy bills, unless absolutely compelled to remit. Again, a whole nation may at a particular moment fall into discredit, and it may become difficult to sell bills on it. Such peculiar contingencies, however, do not occur often and may therefore be ignored as exceptions to the general rule.

We have so far assumed that bills on a particular centre are all payable immediately and are all drawn on first-rate parties. But this is not always the case in real life. Bills vary both as to the *security* behind them and as to the *time* when they are due for payment. A promise made by a man of straw is obviously not so reliable as one by a respectable person and therefore the value attached to a bill of exchange will vary with the standing of the acceptors, other things being equal. For obvious reasons again, no one would give for a promise three months hence, as much as for *cable* or *telegraphic* transfer, payable as soon as the telegram reaches the other centre, or for a *'sight bill'* which is payable on presentation to the drawee or 'a short sight bill', payable after a limited period after sight. Apart from the general *state of indebtedness* then, the price of bills of exchange will depend on their intrinsic *merits* as promises, and the *time* when they are due for payment.

This brings us to another factor—the rate of interest or discount. The cash value of a bill of exchange, payable ninety days hence, will depend on the rate of discount ruling in the centre where the bill is payable. If a man owes money abroad, he will be paying interest to his foreign creditor so long as his debt remains unpaid. Accordingly it will make

[1] See Goschen, Viscount, *Theory of Foreign Exchanges.*

a difference to him of ninety days' interest at the foreign rate, whether the bill he purchases as a remittance is payable at once or ninety days after sight. He will be inclined to make a heavier deduction from the face value of a ninety days' bill when the foreign rate of interest is high than when it is low.

Even in the case of bills of exchange payable *on sight,* the rate of interest is an important element in their price when the centre on which they are drawn is *a distant one.* For instance, even when exchange between London and Sydney was at par in pre-War days, it paid the Australian banker to give more for a sovereign in London, because he received the sovereign in London at once, while his balance in Sydney was drawn upon five weeks later, when the draft arrived there by mail. He had thus the use of the purchaser's money for five weeks; and in times when the rate of interest was high, this was by no means an unimportant consideration.[1]

In the case under discussion then, three main factors influence the price of 'sight bills' drawn on first-rate parties in a foreign centre, namely (1) the state of mutual indebtedness *to be met within a defined period of time;* (2) the cost of shipping specie; and (3) the rate of interest.

4. Let us now take another case—that of places having a gold standard but using a different *coin,* say for instance, Paris and London in pre-War days. The French monetary unit was the franc, while the English unit was the sovereign, and therefore a bill on Paris was payable in francs, while that on London was realizable in sovereigns. The gold contents of the two coins, however, were not the same. The quantity of gold necessary for minting a sovereign in England, would, if taken to the French mints, have sufficed for coining twenty-five francs and twenty-two centimes; and therefore the equation £1 = 25 f. 22 c. was known as the *mint par* of

[1] See Withers, Hartley, *Money Changing.*

exchange. The cost of shipping a sovereign's worth of gold from London to Paris or Paris to London in pre-War days was about 7 c.; and so the pre-War specie or gold points were 25 f. 15 c. and 25 f. 29 c.

The fluctuations of London-Paris exchange within these limits were governed by the same influences which we have considered in the first case, and need therefore no further discussion.

The reader should not conclude from the reasoning followed in these two cases that the rate of exchange between gold standard countries could *never* rise above or fall below the specie points in pre-War days. The facts of real life were not so simple as that. The theory was borne out by facts only where there was a *free market in* gold and a claim for money carried with it an unquestionable right to immediate payment in gold. These conditions existed only in pre-War England. Elsewhere 'the theoretical gold point was only the point at which it paid better to send gold than buy a bill, *if you could get the gold*'. Export of gold was *not free* in other centres and therefore exchange on London in other centres sometimes rose above the theoretical specie point without any specie coming to London. For example, the *mint par* of exchange between Berlin and London was in pre-War times 20 marks 43 pfennigs, and the expense of sending gold from Berlin to London only 5 pfennigs, and yet in November 1912, the Berlin exchange stood for some weeks at or above 20 marks 53 pfennigs without any gold being shipped to London. The same results ensue when the movement of specie (gold and silver) is not only restricted but *stopped altogether,* as is actually the case in times of war. The theoretical 'gold points' are then inoperative, because the alternative of remitting specie is not open to the public, and exchange fluctuations are not limited by them.

In the pre-War times, when there were no

restrictions on the movements of gold, the export of gold from one standard country to another kept within narrow limits the fluctuations in the prices of bills of exchange. It reduced the outstanding balance of the centre which had an unfavourable exchange, and tended to alter the relative price-levels in the two centres in such a way as to provide natural correctives to adverse exchange. For instance, the export of gold from A to B tended to produce a *fall* of prices in A and a *rise* in B ; the resulting higher price-level in B acted as a stimulus to exportation from A to B, and so turned the balance of accounts again in favour of A. Bills drawn in A on B then tended to multiply, and specie point being reached, gold went back from B to A till prices in A were again as high as in B. So long, therefore, as national currencies were *effectively based on gold* and *no impediment was placed on export,* the gold prices of exportable commodities tended to equality everywhere, allowance being made for costs of carriage, frontier taxes, etc., and 'adverse balances' of any magnitude created automatically forces which tended to reduce them.

5. Let us now take a third case into consideration—that of exchange between gold standard countries on the one hand, and those with currencies based either on a free and automatic silver standard or on inconvertible paper on the other. Here there is no such thing as a *mint par* of exchange, nor are there any gold points within which exchange fluctuates. The factors governing exchange in the first two cases, namely the balance of relative indebtedness, the rate of interest in the two centres, and the state of credit are all operative in this case also ; but their influence is considerably modified by variations in the gold price of silver or in the quantity of paper currency in circulation, which changes the purchasing power of the standard in terms of gold, the only international money. For instance, the exchange

between New York and Berlin was subject to violent fluctuations for some years after the War, mainly because the purchasing power of the German mark had been declining fast owing to the over-issue of the German paper currency which was not convertible into gold.

6. There remains still the last and at one time the most common case of exchange between countries, each of which has an independent system of inconvertible paper currency. In this, as in the preceding cases, the *immediate* explanation of exchange movements is to be found in the demand and supply of bills, since all forces affecting the rates of exchange must act through actual buying and selling of bills. But this does not answer *the more fundamental questions* why there should be any demand for a foreign paper currency which is not convertible into any metal, why the demand for bills payable in a foreign inconvertible currency is what it is, and why a person is willing to pay the price asked for them. The theory which answers these questions most satisfactorily is known as the 'purchasing power parity' theory, which has been explained by Professor Gustav Cassel, its leading exponent, as follows :-

'Our willingness to pay a certain price for a foreign money must ultimately and essentially depend on the fact that this money has a purchasing power as against commodities and services in the foreign country. On the other hand, when we offer so and so much of our own money, we offer, in fact, a purchasing power against commodities and services in our own country. Our valuation of a foreign money will, therefore, essentially depend on the relative purchasing power of the currencies of both countries.

'Given a normal freedom of trade between two countries A and B, a rate of exchange will establish itself between them, and this rate will, smaller fluctuations apart, remain unaltered as long as no alteration in the purchasing power of either currency is

made and no special hindrances are imposed upon the trade. But as soon as an inflation takes place in the money of A, and the purchasing power of this money is, therefore, diminished, the value of the A-money in B must necessarily be reduced in the same proportion. And if the B-money is inflated and its purchasing power is lowered, the valuation of the A-money in B will clearly increase in the same proportion. If, for example, the inflation in A has been in the proportion of 320 to 100, and the inflation in B has been in the proportion of 240 to 100, the new rate of exchange will be three-fourths of the old rate. Hence the following rule : when two currencies have been inflated, the new normal rate of exchange will be equal to the old rate multiplied by the quotient between the degrees of inflation of both countries. There will, of course, *always be fluctuations* from this new normal rate, and in a period of transition these fluctuations are apt to be rather wide. But the rate calculated in the way indicated must be regarded as the new parity between the currencies. This parity may be called the purchasing power parity, as it is determined by the quotient of the purchasing powers of the different currencies.'

On analysis, this doctrine will be found to be only a corollary from the following three propositions :—

(1) A currency's internal purchasing power varies with its inflation or deflation in accordance with the quantity theory of money, discussed in chapter II.

(2) Its external purchasing power in a foreign country depends on—

(*a*) the rate of exchange between it and the foreign currency, and

(*b*) the foreign currency's purchasing power in its own country.

(3) In equilibrium, its internal and external purchasing powers must be the same, for otherwise trade would be stimulated to take advantage of any

inequality between the two. It follows, therefore, that the rate of exchange between any two currencies will, in equilibrium, tend to be the ratio between their purchasing powers.

In the practical applications of this doctrine the purchasing power parity between any two currencies is obtained by multiplying the current index number of prices in the country in whose currency the figure is to be expressed, by the pre-War par of exchange, in order to make the two index numbers of prices comparable, and dividing this result by the current index number of the second country. For instance, the purchasing power parity between English and American currencies is taken as equal to

$$\frac{\text{United States index} \times 4.86}{\text{British index}}.$$

It is worth while to note the assumptions on which the practical applications of the theory admittedly rest. It is assumed that the price-levels in 1913, the base year, were in *every* case in agreement with the pre-War par of exchange. It is presupposed that apart from the degree of depreciation which the value of the monetary unit has undergone in any given case, *no other changes have taken place.*[1] It is recognized that the equilibrium between the price-levels and the exchange rates is a necessary one only under conditions of freedom of import or export. It is admitted that the method of calculating the purchasing power parity 'rests strictly on the proviso that the rise in prices in the countries concerned has affected *all* commodities in a *like* degree' and that it has not affected in a particularly high degree those commodities which one country exports to the other.[2] Even if export commodities have actually risen in relative value in the exporting countries, it is assumed that 'they have probably in the importing country also risen in desirability and therefore in

[1] Cassel, Gustav, *Money and Foreign Exchange after 1914*, p. 141.
[2] Ibid., p. 154.

value, as compared with other commodities', and have not caused the exporting country's exchange to be reduced on a like scale.[1]

The exponents of the theory do not deny that the actual rates of exchange do deviate from the purchasing power parities calculated on their method but they ascribe these deviations either to the non-fulfilment of one or more of their assumptions or to the operation of temporary factors. For instance, it is fully recognized that if trade between countries is more obstructed in one direction than in another, then the currency in that country whose export is relatively more hindered will fall in the other country below the purchasing power parity ; and that restrictions such as absolute prohibition of export, export duties, and measures adopted for maintaining higher prices for foreign buyers than those payable in the inland market, will all tend to a corresponding depression of the external value of the currency of the country applying them.[2] Nor is it denied that if the rise in prices in the country A, for example, has affected in a particularly high degree those commodities which that country exports to B, the consequence must be that the A-exchange in B will be depressed to a value somewhat below the purchasing power parity calculated on the basis of the alteration in the general price-level in A.[3] It is also admitted that, owing to distrust in the future of a monetary standard, the market rate of exchange shows sometimes a tendency to anticipate events, so to speak, and becomes more an expression of the internal purchasing power the currency is expected to have in the *future* than of the internal value it actually possesses at the particular moment,[4] and that the external value of a currency is sometimes depressed below the purchasing power parity by speculators

[1] Cassel, Gustav, *Money and Foreign Exchange after 1914*, p. 155.
[2] Ibid., pp. 147-8.
[3] Ibid., p. 154.
[4] Ibid., pp. 149-50.

in exchange[1] or by the practice of selling at *any* price a country's exchange in other countries in order to procure funds in their money.[2] But these depressing factors, it is contended, can *normally* have only a *temporary* influence for, '*if there exist no special obstacles* to the export of commodities from the country in question, then every under-estimate of the country's currency will naturally cause an increased international demand for its commodities which must tend to counterbalance the depreciation of its currency.'[3]

What about the influence of a favourable or unfavourable 'balance of trade' which was regarded as the most important factor in the classical theory of foreign exchanges? The exponents of the purchasing power parity reject the old theory as an explanation of the changes in the *normal* rates of exchange, but they do not deny the influence of trade balances on *temporary* deviations of exchanges from the normal. According to them, the purchasing power parity, in the case of countries on an inconvertible paper currency standard, takes the place of the old mint par of exchange between gold standard countries. It gives the *normal* rate of exchange, the point about which exchanges fluctuate but at which they must ultimately come to rest. It is, however, not a *fixed* ratio like the old mint par : it is a *moving* par, moving with the relative price-levels. Adverse trade balances can and do, cause a 'dislocation of the exchange rate from the *normal* position ; but so long as this normal position itself is not disturbed, this dislocation is usually quite limited'.[4] Their effect is only *temporary,* 'for, if a country buys more from another than it sells to it, the balance must be paid in some way, say by export of securities or by loans in the other country. Thus the balance of payments

[1] Cassel, Gustav, *Money and Foreign Exchange after 1914,* p. 150.
[2] Ibid., loc. cit.
[3] Ibid., p. 149.
[4] Ibid., p. 179.

must on the whole equalize itself, and there is no reason for a definite alteration in the rates of exchange.' With *unaltered price-levels* and *unrestricted export of goods,* an adverse exchange tends to correct itself, for in these circumstances the country's export trade receives a strong stimulus, which tends to bring the exchange back to its old normal rate. But if the relative price-levels are altered by excessive inflation in any country, 'a new normal equilibrium of the exchanges must establish itself, quite irrespective of any balance of trade.' The change in that case is a permanent one : the parity itself has been lowered.

We may here illustrate the difference between the two cases by means of the following diagrams, suggested by Miss E. C. Van Dorp in an article in the *Economic Journal,* 1919.

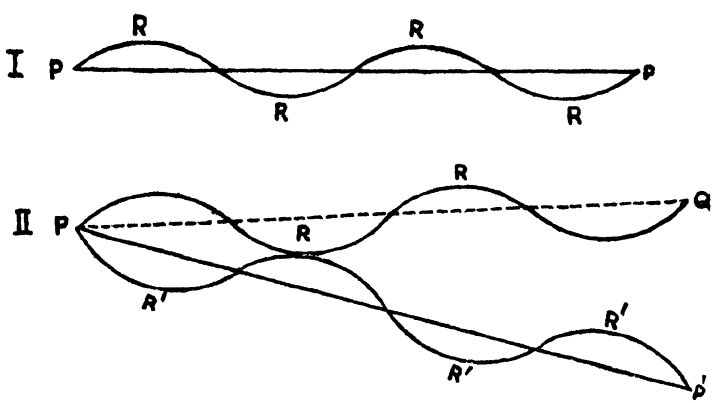

Diagram I shows the fluctuations of exchange with a fixed parity in pre-War times, P-P being the parity and R the rate which fluctuates and tends towards the parity in accordance with fluctuations in the balance of account. Diagram II illustrates the post-War conditions, P-Q being the pre-War

and P-P′ the post-War parity, and R′ the rate. The fall of exchange in this case is not a fall below parity, that is a market rate below the normal rate, but a *fallen parity,* that is a fallen normal rate.

This purchasing power theory proved to be very useful in *explaining* the wayward course of foreign exchanges during the post-War period. It was difficult to account for the violent fluctuations in these 'confounded exchanges' by any other hypothesis. Incidents such as remittances abroad, minor movements in trade balances, or sudden developments in international politics, could not explain, for instance, the following table compiled by the *Statist,* dated 28 October 1922, of the fluctuations in the exchanges of Berlin, Paris, Brussels and Rome with London in the year 1922.

	Berlin (marks to £)	Paris (francs to £)	Brussels (francs to £)	Rome (lire to £)
1921, October 27				
1922, monthly averages till September	680	54·06	55·12	99⅞
April	1,227	47·90	51·90	82½
May	1,289	48·71	53·19	84 9/16
June	1,389	51·54	54·04	89⅜
July	2,185	54·05	56·93	97
August	4,954	56·06	59·14	98⅞
September	6,454	57·82	61·27	103⅝
October 6	9,525	58·15	62·15	103
13	11,750	58·46	62·66	104⅜
20	17,100	60·20	65·00	106½
27	18,625	63·82	68·67	113⅜

That inflation overrode all other factors was clear from a comparison of these with the established index number of wholesale commodities for the countries concerned. The compilations of the

Frankfurter Zeitung for Germany showed an advance in prices from 6,622 per cent above the pre-War level at the end of March (1922) to 28,819 per cent at the end of August (1922). The calculations of the *Statistique Générale de la France* showed a rise for that country during the same period from 207.5 per cent above the pre-War level to 231.2 per cent, while for Italy Professor Bachi's index number indicated an advance during these five months from 433.3 per cent above the 1913 level to 471.2 per cent. The actual results of applying the purchasing power parity theory to the exchange value of sterling, francs and lire in terms of dollars since 1919 showed a decided tendency of the exchange rates and purchasing power parities to come together. The purchasing power parity between Great Britain and the United States[1] was 98.42 per cent of the actual dollar-sterling rate in August 1919, 99.55 per cent in March 1920, 99.87 per cent in July 1921, 100.59 per cent in March and 99.80 per cent in April 1922, and 100.14 per cent in August 1924. Between France[2] and the United States, the purchasing power parity was 97.36 per cent of the actual exchange rate in November 1919, 101.55 per cent in May 1921, 99.11 per cent in March 1922 and 102.92 per cent in March 1924; but the two diverged both in 1922 and in 1923. Between Italy[3] and the United States, the purchasing power parity was 95.71 per cent of the exchange rate in July 1919, 96.42 per cent in May 1921, 98.57 per cent in February 1922, 105.24 per cent in April 1923 and 109.7 per cent in December 1924.[4]

But though useful as a guide in explaining the course of exchange rates, purchasing power parities

[1] On the basis of Great Britain, *Statist* index number, and United States, Bureau of Labour index number.

[2] On the basis of index numbers of *Statistique Générale de la France.*

[3] Index number of Bachi for Italy.

[4] See Young, John Parke, *European Currency and Finance* (Commission of Gold and Silver Inquiry United States Senate 1925), Vol. I, part iv, tables 19, 35, 51.

calculated on the method described above should not be used without caution to *predict* future movements of exchange since, in case of a divergence between the exchange rates and purchasing power parities, even if the figures are correct, it is not possible to say whether exchange rates will move towards purchasing power parities or the other way round. Sometimes it is the exchange rates which are the more sensitive to impending changes in relative prices and move first, whilst in other cases the relation between the internal and external price-level alters before there is any change in exchange movements. Index figures are, again, not an infallible guide, and a certain margin of error has to be allowed since different index numbers sometimes yield somewhat different results and different countries have adopted different methods in the construction of their index numbers of prices. Purchasing power parity studies assume that the price-levels in 1913 were in equilibrium with the par of exchange, but this may very well not have been the case, so that a present divergence of exchange rates from the 1913 relationship of price-levels may not indicate an abnormality. Moreover, there may have been some local peculiarities in the circumstances of the basic year or the character of production may have changed during the period in one or more of the countries concerned. The ordinary index numbers will give no indication of relative changes in the prices of goods which enter into foreign trade and those which do not, while the attempt to construct special indices of export commodities will be futile in cases where, owing to relative dislocations of prices, export commodities are no longer the *same* as they were before the War.[1] Index numbers do not allow for changes in tariffs, freights, and other items of cost in international trade or for other barriers to the free movements of commodities. Nor must we lose sight of the possibility

[1] Cassel, Gustav, *Money and Foreign Exchange after 1914*, p. 155.

of changes in the 'equation of exchange' between the services and products of one country and those of another either on account of movements of capital or reparation payments, or changes in the relative efficiency of labour or in the urgency of the world's demand for a particular country's special products.[1] It is to be remembered also that exchange rates are subject to forces other than those related to the internal value of the currencies, for example disturbed political conditions, the operation of speculators, etc. Altogether, the factors are so many and so complex that it is hazardous to play the prophet's role merely on the basis of a divergence between the exchange rates and the purchasing power parity.[2]

7. We have now seen that *one* of the most important factors governing deviations from the *normal* par of exchange is the state of mutual indebtedness. How does this arise?

(1) The foreign trade of a country is obviously an item in its credit and debit account with other countries. A country has to pay for the goods it imports from outside; it is a debtor to the extent of its imports. It has to be paid for its exports; it is a creditor to the extent of its exports. The exports of a country therefore increase the *supply* of bills of exchange on foreign centres: its imports increase the *demand* for them. For instance, the exporter from India sells his goods abroad and is paid in a bill of exchange on a foreign centre, usually London which is the clearing house of the world. He purchases his produce in terms of *rupees*, but he is paid for his goods in terms of *sterling*, which he would naturally like to convert into rupees. He is therefore a *seller* of a bill of exchange in sterling. On the other hand, the importer in India, for similar reasons, is a *buyer of sterling*. Supply and demand

[1] Keynes, J. M., *A Tract on Monetary Reform*, p. 97.
[2] See also Young, John Parke, *European Currency and Finance*, pp. 38, 296.

for these bills of exchange on London are thus governed by the condition of trade between India and outside; and the rate of exchange will depend on the relation between exports and imports.

Indian exports, being mainly raw agricultural produce, are affected materially by rains and consequently Indian exchange is dependent upon the character of the seasons. Normally, the busy season commences in September and is accompanied by steady exchange conditions. Exchange is most firm during the period October to May and is weakest in the slack season, June to September.

(2) Exports and imports are, however, not the only ground of international indebtedness.

(*a*) International borrowing and lending is another item to be considered. If India borrows a large sum from England, the latter will be in the position of a *debtor* to her during the time the *principal* is being paid to her. This item will therefore figure on the credit side of India's account with England. A foreign loan thus tells against the balance, not of the *borrowing* country which receives the loan, but of the *lending* country which supplies it; its effect is the same as that of additional exports from the country which borrows or that of an increase in imports to the country which lends. In fact, the borrowing country *exports* its *securities* and the lending country *imports* foreign securities. This is the immediate effect of the loan; its ultimate effects are different. The *interest* on the loan will be an item on the debit side of India's account with England; so also will the *repayment* when India begins to repay the loan.

(*b*) Another supplementary cause of international indebtedness arises from the remittances by travellers, by those who reside abroad, and by philanthropists who contribute to the benevolent institutions of a foreign country. The earnings of Indian merchants abroad, so far as they are transmitted to India, make India a creditor, while the earnings of

foreign merchants in India, remitted to their native countries, make India a debtor for the time being. Similarly, the expenditure of the foreigners in India will be an item on the credit side of India's account, while that of Indians going abroad for business, pleasure, or education will figure on the debit side.

(*c*) Remittances by Governments constitute another item in international indebtedness. For instance, the expenditure of the Indian Government in London makes India a debtor to this extent; and the payment of the War indemnity by Germany to France will make Germany a debtor during the time the indemnity is being paid.

(*d*) Lastly there are the payments due by one country to another owing to the commercial services rendered, for example commissions and brokerages, freight, pilot and harbour dues, marine insurance, and other charges of the same sort.

All these items affect the credit and debit side of a country's account just as much as the export and import of *goods*; hence those which figure on the credit side are often called 'invisible exports' and those that have to be placed on the debit side 'invisible imports'.

The statement overleaf compares India's visible balance of account during each of the years 1924-31 with the average of the ten years preceding the War, of the five years of the War, and of the five years ending 1923-4.

It is not easy to gauge aright the exact amount and value of *invisible* exports and imports at any particular moment. The most elusive among them is the purchase and sale of securities between one country and another, being a constantly fluctuating element, partly because of speculation in the stock exchanges of the world, and partly because of the shifting of bills from one centre to another under the influence of varying rates of discount at different

	Average of the ten pre-War years ending 1913-4	Average of the five War years ending 1918-9	Average of the five years ending 1923-4
Balance of trade in merchandise (private)	+71,74	+76,34	+52,49
Balance of transactions in treasure (private)	−28,54	−10,80	−26,12
Balance of remittances of funds	−37,96	−30,14	−6,39
Total visible balance of account	+5,24	+35,40	+19,98

centres. Suppose the rate of discount in London is only three per cent, while that at New York is five per cent. It is cheaper then for a borrower to borrow in London than in New York. A New York borrower is then tempted to do so by drawing what is called a *finance* bill on a London financier, who may have agreed for a consideration to accommodate him by allowing him to draw bills of exchange on him, though he really owes nothing to him. Such a bill of exchange, when accepted by a well-known London financier, is easily turned into cash in the London discount market at the prevailing rate of discount. It can for the same reason be offered for sale in New York just as any commercial bill of exchange, drawn by an exporter of produce in New York on an importer in London. It thus increases the supply of London bills, tends to lower their price, and turn the exchange against London. It is not the *bona fide* borrower alone who resorts to this course when the rate of discount at a foreign centre is low; the *speculator* in exchange finds the course equally profitable to him. If, for instance, the supply of London bills is less then the demand for them in New York and the London exchange rises, the

1924-5	1925-6	1926-7	1927-8	1928-9	1929-30	1930-1
+1,55,18	+1,61,24	+79,29	+81,96	+86,47	+78,98	+61,98
−94,12	−51,88	−39,33	−32,19	−34,36	−26,20	−24,43
−57,14	−62,87	−1,20	−37,84	−41,39	−21,01	+ 8
+9,92	+46,49	+38,76	+11,93	+10,72	+31,77	+37,63

speculator who expects exchange to go down after a short time, will be tempted to increase the supply of London bills by drawing *finance* bills on Londoners. As the price which these bills will fetch in dollars will be more satisfactory to the seller if the discount rate in London is low, the temptation to multiply *finance* bills will increase with every fall in the London discount rate. A low rate of discount in any financial centre thus stimulates the creation of finance bills on it, increases the import of securities from outside, tends to turn the foreign exchanges against it and, to the extent it is a free market in gold, to produce an outflow of gold from it.

8. This outflow of gold was a matter of very serious consequences to the trade of a country in pre-War days, when the great commercial nations of the world were all on a gold basis and so practically used the same currency, gold. Any great depletion of the stock of gold in a country led to a curtailment of credit facilities by banks and note-issuing authorities, whose business required them to keep a proper proportion of cash to demand-liabilities. Adverse exchanges thus threatened to create stringency in the money-market, and led to a sudden withholding

of credit facilities to merchants and traders, who trade largely on credit.[1]

No country could therefore afford to leave its exchange entirely unregulated and different devices were adopted by different countries to prevent a drain of gold in any considerable quantity. England, who in pre-War days was pre-eminently a *creditor* country, attempted to achieve this object by curtailing her short period loans to other countries through a rise in the *market* rate of discount. This was enough to correct adverse exchanges in London, for the balance of accounts of a creditor country like England was, in the absence of any lending operations, *normally* in her *favour*.

The raising of the market rate of discount in London was a comparatively easy matter in days when Bagehot wrote his classic on Lombard Street, for the members of the London discount market then depended upon the Bank of England for the supply of funds to carry on their discount business. A rise in the bank *rate* compelled the discount market to raise its market rate, for the discounting institutions could not afford to lend at a lower rate than the one at which they borrowed funds from the Bank of England. But in subsequent years, the relative position of the Bank of England and other discounting institutions changed considerably. Banks, bill brokers, and discount houses in London came to have large independent funds of their own and did not feel themselves compelled to raise their rate of discount merely because the Bank of England raised its own bank rate.

In order to raise the market rate of discount, the Bank of England was often obliged to assume control of the money-market by *borrowing* money in it. This step reduced the amount of 'cash in hand and

[1] For the post-War practice of neutralizing the gold inflows or outflows by the withdrawal or creation of bank credit see *Macmillan Committee Report*, paras. 41-7.

at the Bank of England' held by other London banks as their first line of defence against a run on them, and compelled them not only to reduce their discounting business but also to call in money lent by them to bill brokers, their second line of defence, with a view to providing themselves with an adequate cash reserve. The market was thus compelled to raise its rate of discount ; in other words, the bank rate became *effective*. [1]

Such, however, was not the case with other gold standard countries. The device of raising the bank rate was, by itself, ineffective against the tendency towards an outward drain of gold produced by adverse changes. It had to be supported by other props in order to achieve the object in view. France depended, for the support of its exchange, upon a large gold reserve and a policy of partial suspension of free payments in gold. Germany resorted to the use of these two props, besides keeping in reserve a large holding of foreign bills and credits which were sold in the international market in case of need. Reliance on these devices, especially the last one, was much more marked in the case of countries of less financial strength like Russia, Austria-Hungary and the Scandinavian countries, Sweden, Norway and Denmark. Thus when the money-market of a country was not a creditor in the international world of finance, the central bank of that country took special care to become one with a view to placing itself, at short notice, in funds at foreign centres in case of a foreign drain of gold. The only other alternatives were, either to hold a large reserve of gold so as to have a surplus always available for export, or to decline temporarily to deliver gold on demand and permit a premium on gold.

The position of India in the money-market of the world was similar to these lesser countries of

[1] For the post-War relations between the discount market and the Bank of England see *Macmillan Committee Report*, para. 95.

Europe : she, too, was a borrower in the international money-market. If she were to adopt a gold standard and regulate its exchange within definite limits, she could only succeed in this object by means of a large reserve in gold or a large holding of foreign securities. This was the governing *idea* behind the currency changes of the period 1893-1900.[1]

[1] For a further treatment of this, see Withers, Hartley, *The Meaning of Money* and Keynes, J. M., *Indian Currency and Finance*.

CHAPTER V

THE GOLD-EXCHANGE STANDARD IN INDIA—ITS THEORY, MECHANISM AND EVOLUTIONARY HISTORY

1. We are now in a position to understand the main features and the underlying principles of the currency system that was established in India during the period 1893-1900.

As stated at the end of the first chapter, the pre-War Indian currency system is commonly described as a *gold-exchange standard*. Its essentials were (1) the use of two currencies, one for local and the other for international purposes, and (2) a mechanism to maintain the value of the local currency in terms of the international at a certain maximum rate. In other words, for all internal purposes the rupee was the standard in India, but for external purposes, that is for payments abroad, *gold* was available in pre-War days at an approximately constant rate in terms of rupees. Its special features then were :—'First, that the actual medium of exchange (was) a local currency distinct from the international currency; second, that the Government (were) more ready to redeem the local currency (rupees) in bills payable in international currency (gold) at a foreign centre (London), than to redeem it outright locally; and third, that the Government having taken on themselves the responsibility for providing local currency in exchange for international currency, and for changing back local currency into international currency, were required to keep two kinds of reserves, one for each of these purposes.'[1]

The system thus involved an attempt to divorce the value of the rupee from the value of the silver

[1] Keynes, J. M., *Indian Currency and Finance.*

in it, and to regulate it artificially at a constant rate in terms of the British sovereign. This, as we have already shown, was impossible so long as India had 'open mints'. The first step in the direction of giving an artificial value to the rupee was, therefore, to close the mints to the free coinage of silver. This was done in 1893 in accordance with the recommendations of a Royal Commission presided over by Lord Herschell. Since then, the value of the rupee has not depended on the market value of its silver contents except for a short period during the War.

Through the operation of certain forces which have been examined elsewhere,[1] the value of the rupee rose gradually, in relation to gold, from 13*d.* in 1895, to 15⅓*d.* in 1898, and to 16*d.* in 1899. From that year onward till 1917, the external value of the rupee was fixed in the neighbourhood of 1*s.* 4*d.*

2. How did Government attempt to prevent a rise in the value of the rupee above this level? Suppose at any time there was a tendency for the rupee-sterling exchange to rise above 1*s.* 4*d.* owing, say, to a favourable balance of account. There would then be an increase in the demand for remittance to India and if the tendency to a rise in exchange was to be counteracted, there must be adequate means of meeting this increased demand. Government provided these in three different ways :— (1) They undertook in 1893 to accept in payment of sums due from the public, sovereigns and half-sovereigns at fifteen rupees to the pound sterling, and declared in 1899 that sovereigns and half-sovereigns coined at any royal mint were legal tender in India at the rate of one sovereign for fifteen rupees. This enabled foreigners to discharge their obligations to Indian merchants by *exporting* sovereigns to India. (2) They further undertook to issue to the public through the Controller of Paper Currency and the Mint Masters, currency notes and silver rupees in

[1] See my *Studies in Indian Currency and Exchange*, loc. cit.

exchange for gold coin and bullion at the rate of 1*s.* 4*d.* to the rupee, or fifteen rupees to the pound sterling. In effect this amounted to an undertaking on the part of Government to supply an unlimited quantity of rupees at this rate, and so the value of the rupee could not possibly go appreciably higher than this. (3) As the demand for Indian currency came mostly from foreign merchants who imported sovereigns into India only to exchange them into rupees, Government came forward to offer them rupees *in India* in exchange for sovereigns *in London* by selling *Council Bills* (that is bills drawn by the India Council on the Indian Government) at a rate approximately of a rupee for 1*s.* 4*d.* To some extent, this was convenient both to British merchants and to the Indian Government. It practically amounted to a remittance *in rupees* from the British importer to the seller of Indian produce in India. Government were thus obliged to provide large *reserves* of rupees in India to meet the 'demands of trade' for Council Bills. These consisted of (*a*) the cash balances at the Indian treasuries, (*b*) rupees in the Paper Currency Reserve in India, (*c*) the rupee section of the Gold Standard Reserve, built up out of the profits from coinage, and (*d*) the new coinage from the mints, when necessary. All these measures were calculated to provide adequate means of increasing the supply of local currency to any amount necessary to bring *down* the value of the rupee very nearly to 1*s.* 4*d.*, and proved, till 1917, quite effective in preventing the specific appreciation of the rupee in terms of sterling *above this level.*

3. This, however, was only one side of the problem of rupee-sterling exchange, and by no means the more important one. The motive behind the monetary changes of the period 1893-9 was the desire of Government to prevent a *fall* and not a *rise* in the gold value of the rupee. Suppose the rupee showed a tendency to depreciate in terms of

the British sovereign owing to an unfavourable balance of accounts. How was such a situation to be met?

It was obviously unwise at such a moment to continue to sell Council Bills in the same volume as before; that would only tend to depreciate further the sterling value of the rupee. (1) The first thing that the Secretary of State had to do in times of weak exchange was, therefore, to support it by greatly *restricting* the sale of Council Bills, and if he could not get at least 1*s.* $3\frac{29}{32}$*d.*, by *completely withdrawing* from the exchange-market. (2) In such a contingency, he had to devise some other means of recovering money from India to meet his expenditure on behalf of India in London. He had to fall back upon his *cash balances* in London, and if they proved insufficient, on the *gold branch* of the Indian Paper Currency Reserve in London. The Indian Government had to transfer at the same time equivalent amounts in rupees to the Paper Currency Reserve in India, in order that the total value of the Indian Paper Currency Reserve as *a whole* might remain the same as before. (3) It was possible that at times even this complete cessation of the sale of Council Bills might prove insufficient to restore exchange to its old parity, 1*s.* 4*d.* On such occasions, Government were to *withdraw rupees* from circulation in India by selling *Reverse Council Bills* (that is bills drawn by the Indian Government on the Secretary of State in London), payable in sterling at the rate of 1*s.* $3\frac{29}{32}$*d.* for a rupee out of India's *gold reserves kept in London.* This *by itself* would amount to a process of *deflation* or a *contraction* of rupees or notes in circulation in India. The resulting scarcity of Indian currency, other things remaining the same, would, therefore, tend to restore the value of the rupee back to its fixed parity.

The first set of measures described in paragraph two thus prevented the sterling value of the rupee

from *rising above* 1*s.* 4*d.* by more than the cost of remitting sovereigns to India, while the second set enumerated in paragraph three prevented it from *falling below* 1*s.* $3\frac{29}{32}$ *d.* In other words, the extreme limits of variation of the rupee-sterling exchange were 1*s.* $4\frac{1}{8}$*d.* and 1*s.* $3\frac{29}{32}$*d.* 'These variations were intended to, and did correspond to, the differences which in normal times constantly occur between actual exchange rates and theoretical par of exchange in transactions between countries of which both are on a gold standard with free import and export of gold in both directions.'[1]

4. The pre-War Indian currency system, like all other gold-exchange standard systems, was thus based on the following three principles :—

(1) Government control of the amount of currency so as to keep it within the demands of trade for legal tender money.

(2) Acceptance of coins at their legal value for public dues and private debts.

(3) The sale of drafts at or near par upon gold-exchange funds kept at the financial centre of the world.

We may now sum up the main features of the pre-War currency system of India as follows :—

(1) The Indian mints were closed to the free coinage of silver, the control over the amount of new silver coinage being exercised entirely by Government.

(2) The British sovereign was unlimited legal tender in India at the rate of one sovereign for fifteen rupees and was convertible at this rate.

(3) The rupee too remained legal tender without limit of amount, but it was *not convertible* into gold under the *law,* though as a matter of convenience, Government were sometimes willing to exchange

[1] Sir Lionel Abraham's Memorandum A before the Babington Smith Committee.

sovereigns for rupees at the rate of fifteen rupees to the pound sterling.

(4) The sterling value of the rupee was so regulated as to confine its fluctuations within the upper limit 1*s.* $4\frac{1}{8}$*d.* and the lower limit 1*s.* $3\frac{29}{32}$ *d.*

(5) With a view to working this system of regulating the value of the rupee, Government became one of the largest exchange dealers in the market, and had to keep two kinds of reserves, the one mainly in rupees and the other chiefly in sterling, the one located in India and the other in London. Both in India and London these reserves were kept in three compartments. The reserves in India consisted of (*a*) the treasury balances, (*b*) the Paper Currency Reserve and (*c*) the Gold Standard Reserve; the reserves in London included (*a*) the India Office balances, (*b*) the London branch of the Paper Currency Reserve and (*c*) the London branch of the Gold Standard Reserve. Although each of these was created for a specific object, all were available in case of need for the general object of *supporting exchange,* and thus constituted '*practically one single fund*'.[1]

5. The foregoing paragraphs must not lead the reader to think that the system described therein was deliberately adopted as a *consistent whole* in 1893 or even in 1899. Like all other English institutions, it was 'the result of a series of experiments' extending over a fairly long period. The authorities had no clear idea of the final object to be attained in 1893 or in 1899. The different parts of the system were created at different dates, and the system as a whole was the *final result* of piecemeal changes, brought about more by the logic of events than by systematic thinking on the part of any particular individual or individuals. It was only in 1913 that these different changes came to be reviewed and examined as parts of a whole; it is only since then that the

[1] Chamberlain Commission.

authorities have come to be finally committed to the maintenance of the gold-exchange standard.

A brief history of the currency changes between 1893 and 1910 is therefore necessary for understanding clearly the evolutionary nature of the growth of the system. The first date to note is the year 1892, when a Royal Commission known as the Herschell Committee was appointed to suggest measures for preventing constant fluctuations in exchange, due to the steady fall in the value of silver during the preceding two decades. Their report was submitted in 1893, and in pursuance of their recommendations, Government closed the Indian mints to the free coinage of silver and issued a notification fixing 1*s.* 4*d.* per rupee as the rate at which rupees or notes would be supplied by the Commissioners of Paper Currency and Mint Masters in exchange for gold coin and bullion. In 1898, Government appointed another Royal Commission with Sir Henry H. Fowler, M. P., as chairman to consider the results attained by the previous measures, and advise Government as to the policy to be pursued thereafter. Soon after the appointment of the Commission, exchange touched 1*s.* 4*d.* and conditions continued so favourable to this rate during the succeeding months, that by the time the Committee issued their report, over £4,500,000 of gold tendered in exchange for notes at the rate of 1*s.* 4*d.* per rupee had accumulated in the Paper Currency Reserve in India. This encouraged Government to pass Acts Nos. II and VIII of 1898, authorizing the issue of notes in India against gold held *in London* by the Secretary of State and earmarked at the Bank of England as part of the Indian Paper Currency Reserve, and to sell freely Council Drafts in London to meet 'the demands of trade' for rupees or notes in India. The report of the Fowler Committee approved of the closure of the mints, and decided in favour of fixing the rupee permanently at 1*s.* 4*d.* The Commissioners

looked forward to 'the effective establishment of a *gold standard and currency* based on the principles of the free inflow and outflow of gold', and recommended several measures with a view to making an appreciable advance towards that goal. In pursuance of their recommendations, Government passed Act XXII of 1899, declaring sovereigns and half-sovereigns legal tender throughout India at the rate of one sovereign for fifteen rupees and set apart in 1900 the profits on the coinage of rupees to form a special reserve subsequently known as the Gold Standard Reserve. Contrary to the idea of the Fowler Committee, the reserve was, however, located not in India but in *London*. Although gold coins were now legal tender in India and Government made an active effort to induce people to use sovereigns as a medium of circulation, the public continued to demand rupees, and eventually forced Government to *resume* the coinage of rupees in 1900. This fresh coinage necessitated recourse to the London silver market, and Government asked from the Legislature temporary authority to use the gold held in the paper currency chest in London for the purchase of silver and coinage, and to treat the silver so purchased as part of the reserve against notes in circulation during the interval between purchase and mintage. Act IX of 1902 made this arrangement permanent. In 1904, the continuous demand for rupees in India was met by a notification of the Secretary of State, signifying his willingness to sell Council Bills on India at 1*s*. 4⅛*d*. to the rupee *without limit*. In 1905, further demand for rupees made it necessary to provide the Secretary of State with sufficient sterling resources in London to be utilized for the purchase of silver and this was done by shipping to London 5,000,000 sovereigns out of the accumulated stock in the Paper Currency Reserve in India to be held as part of that reserve in London. In 1906-7, the need of providing larger reserves of rupees in order to meet

the increasing demand for remittance to India, led Government to institute the rupee branch of the Gold Standard Reserve, which thenceforward consisted of two portions, one held in sterling in London, the other in rupees in India. So far, the Indian currency system had met with only fair weather but a partial failure of the summer monsoon in 1907 caused the Indian exchange to be weak in November 1907. Government were then obliged to have recourse to all the expedients described in a previous paragraph for preventing a fall in the value of the rupee, including the sale of Reverse Council Bills or sterling drafts on London at 1*s.* 3 $\frac{29}{32}$*d.* to the rupee. The system had by this time developed all the essential features of a gold-exchange standard, and came as such under the searching examination of the Chamberlain Commission in 1913. The report of the Commission endorsed generally the policy and principles underlying the establishment of the gold-exchange standard in India, but made important recommendations regarding 'the use of gold as currency, the minting of gold in India, the development of note-issue, the utilization of Government balances, the sale of drafts on India and London, the constitution and location of the Gold Standard and Paper Currency Reserves, the organization for the discharge of financial business at the India Office and the question of establishing a State or central bank in India'. While these recommendations were still under consideration, the War broke out and 'it was decided to postpone further action until the return of normal conditions'.

CHAPTER VI

THE INDIAN EXCHANGE-MARKET IN PRE-WAR DAYS

1. We have examined in chapter IV the natural forces that cause fluctuations in exchange, and noted in chapter V the fact that exchange between India and England in pre-War days was not left merely to the automatic working of these natural forces, but was regulated by Government. They attempted to fix the upper and lower limits of the rupee-sterling exchange by entering the exchange-market whenever the price of sterling rose above or fell below certain points. In practice, this amounted to regulating not merely the exchange between India and England, but also, within limits, that between India and other foreign centres, for most of the transactions in foreign trade were either settled in sterling or passed through London, the clearing house of the world in pre-War days. The rupee-sterling exchange was then the dominating factor in the Bombay or Calcutta exchange with all foreign commercial and financial centres, and was practically the only exchange in which practical business men felt themselves interested.

2. Let us now glance at the constituent members of this rupee-sterling exchange-market. As already explained in a previous chapter, it consists of buyers and sellers of sterling bills in India. Among the former, we have already mentioned the importers of merchandise who have to pay for their imports; next, we have the exchange banks and bullion dealers who import specie into India and pay for it in London; thirdly, there is the group of miscellaneous people who on various grounds have to remit money to London; and lastly, there is the Government

who figure as buyers of sterling when they take over imported specie or when they cash the Secretary of State's Council Drafts. Similarly sterling bills are sold by (1) exporters of Indian produce; (2) by exchange banks and bullion dealers when they export specie; (3) importers of funds from England into India; and (4) Government when they sell Reverse Councils. As the most important of the members enumerated above are (1) the exchange banks and (2) the Government, the part played by each deserves a somewhat detailed description.

3. Like all other banks, the exchange banks receive deposits, grant loans, and deal in overdrafts and discounts, but the characteristic part of their business, and the one which distinguishes them from other banks, consists in their financing India's foreign trade and dealing in Indian exchange. They employ a large part of their funds in purchasing or discounting bills of exchange, particularly those which are drawn against export trade. These are of two kinds :—(1) The 'documents against acceptance' (D. A.'s), that is the documents which will enable the buyer of goods to get the goods from the shipper or the warehouse of a bank, on his 'accepting' the bill; and (2) bills against which the documents will only be given up on payment (D. P.'s). They are usually drawn at three months' sight. As the exchange banks generally discount far more of these bills than their own funds would warrant, they have to obtain the necessary additional cash in London by rediscounting the D.A.'s in London. They experience no difficulty in this matter, as these bills are generally drawn on and accepted by well-known London houses. The bulk of the Indian export trade is thus financed by funds borrowed from the London money-market.

The London branches of these banks deal also in bills negotiated in London and drawn on Indian importers. As a rule, these bills are not rediscounted,

the exchange banks using largely their own funds to finance the import trade.[1]

As, in pre-War days, India had usually a favourable balance of trade and bills against exports exceeded those against imports, the exchange banks were very often in possession of larger funds in London than they could utilize there in financing India's import trade. These surplus funds were badly needed in India for the purchase or discount of export bills and so they remitted them to India by (1) buying the Secretary of State's Council Bills, giving sterling in London in exchange for rupees in India; and (2) shipping to India sovereigns or bullion (gold or silver) in large amounts.

4. These exchange banks were the best customers for the Secretary of State's Council Bills. Although himself one of the largest dealers in exchange, he did not compete with them for business in Indian exchange. He conducted his exchange business not *directly* with the trading public but only *indirectly* through the exchange banks. He was their ultimate source of supply for bills on India. His Council Bills, when sold below the rate at which it was profitable to ship sovereigns or specie to India, provided them with easy means of transferring their funds from England to India.

The procedure followed by the Secretary of State in selling these Council Bills in pre-War days is described by the Chamberlain Commission as follows :—'On each Wednesday, a notice is exhibited at the Bank of England inviting tenders to be submitted on the following Wednesday, for bills of exchange and telegraphic transfers on the Indian Government authorities at Calcutta, Madras and Bombay. The notice states a limit which the aggregate amounts will not exceed. The Secretary of State does not bind himself to allot the whole

[1] For a fuller description of the mechanism of finance see *Indian Central Banking Inquiry Committee Report*, paras. 427-9.

amount mentioned in the notice, and as a matter of practice does not accept any applications at a price lower than 1*s.* $3\frac{15}{16}$*d.* for *transfers*. The price charged for telegraphic transfer is ordinarily higher by $\frac{1}{32}$*d.* per rupee than that charged for bills, but when the Calcutta or Bombay bank rate exceeds 8 per cent, tenders for transfers rank for allotment with tenders for bills only if they are $\frac{1}{16}$ *d.* higher. Allotment is made to the highest bidders and when the total amount exceeds the amount offered, allotment is made *pro rata*. When the tenders received on Wednesday have been dealt with, the amount to be offered for tender on the following Wednesday is decided upon, the main consideration being the requirements of the India Office, and the strength of the demand. "Intermediate" or "special" bills and transfers can be obtained on other days of the week at a price fixed by the India Office at not less than $\frac{1}{32}$*d.* higher than the lowest prices at which allotments have been made on the preceding Wednesday, the exact rate and the maximum amount of such "intermediate" being fixed for the week each Wednesday.'

It will be seen from the above that the price charged for telegraphic transfers was usually $\frac{1}{32}$ *d.* per rupee higher than that for bills. The reason for this is easy to understand. The bills could not be changed into rupees at Calcutta, Bombay, or Madras for about a fortnight after the sale, on account of the time taken by the mail, but 'telegraphic transfers' could be encashed in India only a few hours after the Secretary of State received their sterling price in London. The purchaser of a telegraphic transfer thus obtained his rupees in India a fortnight earlier and was on that account asked to pay for this privilege a sum equal to 5 per cent on the money for a fortnight, that is about $\frac{1}{2}$*d.* per pound or $\frac{1}{32}$ *d.* per rupee. If, however, the rate of interest in India at any time exceeded 8 per cent, he was made to

pay $\frac{1}{16}d.$ per rupee, that is approximately the interest on a rupee for a fortnight at the rate of 10 per cent.

What determined the amount of the Council Bills sold by the Secretary of State for India? Government policy, in this respect, has varied from time to time with the change of ideas regarding the object of Council Bills. Up to the year 1898, this weekly auction of Council Drafts was nothing more than a cheap and simple means of remitting money to the India Office on account of various items (including interest on the public debt of India, pensions and furlough allowances of retired civil and military officers, purchase of stores in London on behalf of the Indian Government, expenditure of the India Office, etc.) known collectively as the *home charges*. Till then, the volume of the Council Bills sold was mainly determined by the amount required to defray the home charges, though occasionally the Secretary of State took advantage of a favourable rate of exchange to transfer to London more than was needed for this purpose, 'but the system existed simply as a means of remitting to London so much of the Government balances as it was desirable to make available in London. Its main justification lay in the fact that it was both effective and profitable to the Indian Government, and convenient to trade in providing a ready means of selling a large part of the debts due by people in this country (England) and elsewhere to people in India for the surplus of exports over imports.'[1]

After 1898, the function of these Council Bills was enlarged and, as already explained in chapter V, they became a very important part of the general mechanism for the maintenance of the gold-exchange standard. They were thereafter used as a means of preventing the inflow into India of sovereigns and their re-export by Government to London, either for the purpose of purchasing silver for fresh

[1] Chamberlain Commission.

coinage of rupees, or to 'avoid the useless accumulation of gold in the Paper Currency Reserve in India'. Suppose India had in any year a favourable balance of trade, and sovereigns flowed into her and were presented at the Government treasuries for encashment into rupees or notes. Government would then be obliged to mint more rupees, the silver needed for this purpose would be purchased in London, and sovereigns would have to be shipped back to London, either to pay for this silver, or to be credited to the Gold Standard Reserve there as profits from new coinage. To avoid this double loss—the cost of sending gold to India and the expense of bringing it back to London—the Secretary of State considered it necessary to 'sell sufficient drafts, not merely to meet his own requirements on revenue and capital account, but also to satisfy *the demands of trade* up to such an amount as will enable the balance of trade in India's favour, over and above the amount of home charges on revenue and capital account, to be settled without the export to India, on private account, of more gold than is actually required in India for absorption by the public'. Thus the Council Drafts were 'sold *freely*', that is to say as long as there was a demand for them and as long as it could be met from the rupee resources of Government.

In 1913, the Chamberlain Commission were asked by various witnesses to consider various limitations on the amount of Council Bills to be sold, and to lay down a rule for future guidance. They rejected the suggestion that the Secretary of State should *never* sell more than the amount of his home charges, or that he should adjust the sales in such a manner as always to keep his cash balances from rising much above the working figure of £4,000,000. Nor did they approve of the principle that the *demands of trade* should be the only determining factor in the volume of the Council Bills sold. Their view was

that the extent of the sale of the Council Drafts should depend on the '*requirements of Government*; whether *immediate or prospective* for funds in London'. Though they recognized *that convenience of trade* and *regulation* of exchange were important considerations for the India Office in the management of this system, they thought that in some of the official explanations on the subject, too much stress had been laid upon these aspects and too little attention given to the *primary* and by far the most important function of the Council Drafts, namely the transfer to London from India of public funds to meet the requirements of the Secretary of State in London; and they came to the conclusion that '*the interests of trade were in themselves no justification*' for selling Council Drafts in excess of the Secretary of State's needs, immediate and *prospective*, for, if to accommodate trade, the Secretary of State were actually to go beyond this standard, 'it would mean that he would bring to London money for which he had no need and that sooner or later he would have to send it back to India.'

It is evident from what has been said above that in pre-War days the volume of Council Bills depended partly, at any rate, upon the discretion of the Secretary of State. But he was not in the position of a monopolist who could, by limiting the supply of a commodity, dictate his own price, for the Council Bills were *not the only means of making remittances to India*. As the British sovereign was legal tender at the rate of fifteen rupees per sovereign the export of sovereigns to India provided an alternative mode of remittance. The price of Council Bills could not therefore exceed the equivalent amount of sovereigns (calculated at the rate of fifteen rupees per pound) plus the *cost* of sending sovereigns to India. In pre-War days this did not generally go beyond $\frac{1}{8}d.$ per rupee and so the maximum value of the rupee was then $1s.\ 4\frac{1}{8}d.$ But sometimes it was a good deal less

than $\frac{1}{8}d.$ and as it depended upon a number of variable factors governing its component items (insurance, freight, and interest during the period of transit), it was not always easy to say exactly at what price the export of gold to India would become a serious competitor of bills as a means of remittance. Occasionally, sovereigns in transit from Australia to London or those ready for export from Egypt were bought by the banks as the cheapest form of remittance to India, and the Secretary of State was obliged to cut down his price for Council Bills owing to this competition.

The Secretary of State then, was the largest dealer in the rupee-sterling exchange-market and was able, to some extent, to control the level of this exchange by regulating his sales of Council Bills. But these bills were not the only means of adjusting India's trade balances. The precious metals played, in this adjustment, a part only a little less important than Council Drafts, as can easily be seen from the following table (given in the Babington Smith Committee's report) indicating the balance of trade on private account, the net imports of treasure on private account, and the sales of Council Drafts for the period 1904-14.

Year	Excess of exports over imports on private account	Net imports of treasure on private account (gold and silver coin and bullion)	Net sales of Council Drafts (that is Council Drafts less Reverse Drafts)
	Rs.	Rs.	Rs.
1904-5 ...	4,05,48,200	1,67,00,600	2,41,50,000
1905-6 ...	3,90,86,700	96,46,900	3,18,86,000
1906-7 ...	4,55,06,600	1,44,20,000	3,40,69,400
1907-8 ...	3,16,40,000	1,82,53,300	1,56,76,700
1908-9 ...	2,11,73,300	1,11,16,300	53,35,300
Total ...	17,79,54,800	7,01,37,100	11,11,17,400

Year	Excess of exports over imports on private account	Net imports of treasure on private account (gold and silver coin and bullion)	Net sales of Council Drafts (that is Council Drafts less Reverse Drafts)
	Rs.	Rs.	Rs.
1909-10 ...	4,72,13,000	2,06,88,000	2,77,10,600
1910-1 ...	5,36,85,300	2,17,00,000	2,63,89,800
1911-2 ...	5,95,12,900	2,87,06,000	2,69,17,500
1912-3 ...	5,70,20,900	2,94,35,000	2,59,83,500
1913-4 ...	4,37,53,900	1,97,13,000	3,12,00,800
Total ...	26,11,86,000	12,02,42,000	13,82,02,200

CHAPTER VII

THE INDIAN CURRENCY SYSTEM DURING THE PERIOD 1914-9

1. We have so far dealt with the Indian currency system as it existed up to the year 1914; we have now to notice the effects of the War on it.

At the first shock of the War, a sense of insecurity prevailed in the country and from the month of August 1914 to the early autumn of 1915, a general dislocation of trade and business led to a weakening of exchange, withdrawals of Savings Bank deposits, demand for conversion of notes, and a scramble for gold. Government met the situation boldly. They supported exchange by selling Reverse Councils to the extent of £8,707,000 between 6 August 1914 and 28 January 1915. This greatly restored confidence and thereafter for nearly two years the fluctuations of Indian exchange were insignificant. The run on the Savings Banks resulted in net withdrawals of over 8 crores of rupees during the year 1914-5 but the promptness with which Government met all claims soon restored confidence and the tide turned in 1915-6, when deposits began to increase again. The abnormal demand for the conversion of currency notes into rupees resulted in a net return of currency notes to the extent of 10 crores between 31 July 1914 and 31 March 1915 but the steps taken to meet this demand for encashment checked uneasiness and the crisis passed away in the spring of 1915. The keen demand for gold in exchange for notes resulted in the loss, by Government, of about £1,800,000 of gold between 1 and 4 August 1914 and forced Government to suspend the issue of gold to the public from 5 August 1914.

On the whole, the disquieting symptoms lasted only for a short period and with the restoration of confidence, the Indian Government found it unnecessary to have recourse either to the expedient of a moratorium or to the inconvertibility of the note-issue, as Governments of many European countries found it necessary to do during this period. The mechanism of the Indian currency system worked quite smoothly right up to the end of 1916 but new complications arose soon after that.

2. Several causes contributed to these new difficulties. In the first place, the balance of trade in India's favour began to increase. Taking the three years 1916-7, 1917-8, and 1918-9, we find that the average balance of trade in India's favour rose to £59,601,100 as against £53,429,200, the average of the last three years of the pre-War period (1911-2 to 1913-4). This increased greatly the demand for local currency, which was further intensified by exceptional disbursements made by the Government of India on behalf of His Majesty's Government, amounting to over £240,000,000 during the five years 1914-9.

The Government of India, however, were at this time in a particularly unfavourable position for meeting this large demand for currency. There was a marked reduction during the War of imports of gold from Australia and Egypt, which had been important sources of the supply of sovereigns, while gold imports from other countries were checked by the restrictions imposed by the Allied Governments. Unlike other creditors of the belligerent Governments, India was not paid in gold for the services she rendered to them. During the War the gold in the United States Federal Reserve system increased from 592 to 1,786 million dollars or approximately 250 million pounds sterling; that in Spain by 70 million pounds; in the Netherlands by 43 million pounds; in Switzerland by 10 million pounds; and

in Norway and Sweden by 14 million pounds ; but the net import of gold into India during the same period was only 26 million pounds. In other words, countries with a population of 114 millions increased their gold reserves by 387 million pounds, while India, with a population nearly three times as large, was allowed to have in the same period only 26 million pounds.

At the same time, there was a heavy decline in the net imports into India of *silver* coin and bullion on private account. They fell off from a total of 24 million pounds in the five pre-War years to less than 10 million pounds during the five years 1914-5—1918-9. The burden of liquidating India's favourable balance of account, therefore, fell wholly on the supply of rupees or notes by the Indian Government through their sales of Council Bills. They were obliged to make heavy purchases of silver and set the mints actively to work. But during this period, the silver market of the world was subject to conditions of supply and demand very unfavourable to purchasers of silver. There was, in the first place, a marked decline in the world's production of white metal, the average for the four years 1914-7 being only 178,075,000 fine ounces as against an average of 228,552,000 ounces for the four years 1910-3. In the second place, the world demand for silver, particularly for coinage, was unusually keen. These causes combined to send up the price of silver from 27¼*d.* per standard ounce in 1915 to 35⅛*d.* in April and 37*d.* in December 1916, and to 43*d.* in August 1917—*a point at which the exchange value of the rupee at 1s. 4d. was equivalent to its bullion value.* In September 1917, the United States Government attempted to arrest the rising tendency of silver prices by prohibiting the export of the metal except under licence, but in spite of this control, the London price of silver ranged between 47¾*d.* and 50*d.* per standard ounce from May 1918 to April 1919.

3. In these circumstances, the Government of India were unable to meet the heavy and continuous demand for silver coin without considerable loss at the customary rate of exchange, and were therefore driven to the conclusion that the maintenance of the pre-War currency and exchange system was impracticable. They met the situation by resorting to exceptional measures.

(1) The Secretary of State withdrew his offer to sell Council Drafts without limit of amount, and limited his sales to a fixed weekly amount, varying between 120 and 130 lakhs. As this amount was insufficient to finance the whole of the Indian export trade, Government introduced certain measures of control with a view to according preferential treatment to exports required for War purposes. They sold Council Drafts, not at rates tendered by prospective buyers, but at a fixed rate, determined from time to time by the Secretary of State, and confined these sales to persons on the 'approved list' who were required to do business with other institutions and firms only at prescribed rates, and to apply their resources primarily to financing the export of articles required by the Allies for the purpose of the War.

(2) In view of the rise in the price of silver to a level higher than that which corresponded to a bullion value of 1*s.* 4*d.* for the rupee, the Secretary of State was compelled to raise, from time to time, the rate at which he sold this limited amount of his Council Drafts. The successive steps of these changes in the rate of exchange are shown in the following table.

Date of introduction	Minimum rate for immediate telegraphic transfers		
		s.	*d.*
3 January 1917	...	1	4¼
28 August 1917	...	1	5
12 April 1918	...	1	6
13 May 1919	...	1	8

Date of introduction	Minimum rate for immediate telegraphic transfers	
	s.	*d.*
15 September 1919	... 2	0
22 November 1919	... 2	2
12 December 1919	... 2	4

4. In addition to these fundamental changes, several supplementary measures were taken to enable Government to cope with the heavy demand for currency and to conserve adequate metallic resources for this purpose. On 29 June 1917 an ordinance was issued requiring all gold imported into India to be sold to Government at a stated price, based on the exchange value of the rupee, and declaring the use of silver or gold coin for other than currency purposes as illegal. On 3 September 1917 Government prohibited the export of silver from India, as also its import on *private account*. The use of silver was further economized by the issue of 2½-rupee notes in December 1917, of 1-rupee notes in January 1918, and of a new 2-anna nickel coin in March 1918. But all these measures proved insufficient for the needs of the situation. The demand for currency continued unabated and Government had no option but to rely more and more on their issue of paper currency as a means of satisfying the insistent demand of the country for currency. This course brought the country almost to the verge of inconvertibility. In April 1918 the position at Bombay became most critical. 'Rupees were pouring out to finance the cotton crop at fanciful prices. Bad news from France brought a run upon our currency offices by timid holders of our notes. Our visible reserve of silver had dwindled to insignificance, and for several days the maintenance of specie payments hung in the balance.' The crisis was averted only by the diplomacy of Lord Reading who induced the United States Government to sell to India 200,000,000 fine ounces of silver at 10½ cents per fine ounce—a supply

of silver which represented considerably more than the world's annual mine production since 1914.

The period 1916-9 is marked by several other changes in the Indian currency system. A branch of the Royal Mint was opened at Bombay in August 1918 for the coinage of sovereigns from gold tendered to the Deputy Master by the Government of India. The Indian paper currency system underwent substantial modifications, which we have already noticed in chapter III. Apart from a complete departure from the pre-War system of free and unlimited sales of Council Drafts referred to in a previous paragraph, two minor changes were made in the system of Council Bills. The sales were made on Tuesdays instead of Wednesdays and a system of 'deferred drafts', payable sixteen days after the departure of the weekly mail (introduced for the first time shortly after the outbreak of War owing to the uncertainty of mails) proved so convenient to the public as entirely to replace 'bills' throughout the period.

The War left its marks on the composition and the total amount of the Gold Standard Reserve also. We have already dealt with the history of this reserve in chapter V, noticed how it was built up out of the profits of rupee coinage and located partly in London and partly in India, and explained the part it was intended it should play in the working of the gold-exchange standard. Its composition on 31 March 1913 was as follows :—

	£
Gold in London	1,620,000
,, ,, India	nil
Silver in India branch—6 crores at 1*s.* 4*d.*	4,000,000
Securities at market value	15,945,669
Money lent at short notice ...	1,005,664
	22,571,333

The Chamberlain Commission were of the opinion that the proper place for the location of the *whole* of

this reserve was London as 'London is the clearing house of the world, India's chief customer is the United Kingdom, and London is the place where money is required both for the expenditure of the Secretary of State on India's behalf and for payment of India's commercial obligations to this country (England) and the world in general'. The *rupee* branch of the Gold Standard Reserve was therefore abolished in August 1915. The Commissioners had further recommended that a *substantial* portion of the Reserve should be held in *actual gold,* for 'the realization in a crisis of securities in large quantities, and even the calling in of sums lent out at short notice, is likely to cause some stringency in the London market, and if the exchange crisis in India which makes such realization necessary is accompanied or directly caused by a financial crisis in London or reacting upon London, as is very probable, the difficulty of realization may be accentuated, and the possibility of loss to India cannot be ignored'. Disregarding this recommendation, Government allowed the percentage of gold to the total reserve to fall from 24 per cent in 1915 to only 3 per cent in 1917, and almost to nothing in 1919. On 30 November 1919 it was constituted as follows, the figures given representing in each case the face value of the security :—

	£
Cash	27,093
British Treasury Bills maturing between December 1919 and March 1920 ...	8,219,000
Exchequer Bonds redeemable between February 1920 and October 1921 ...	16,199,300
National War Bonds redeemable 1 October 1922	7,500,000
5 per cent War Loan 1929-47	3,762,181
Local Loans 3 per cent Stock	200,000
Irish Land Stock 2¾ per cent	438,720
Transvaal Government Guaranteed Stock 1928-53	1,092,023
Total ...	37,438,317

CHAPTER VIII

INDIAN CURRENCY AND EXCHANGE IN 1920-3

1. The events described in the last chapter were the subject of examination by the Babington Smith Committee which was appointed on 30 May 1919 with the following terms of reference :—'To examine the effect of the War on the Indian exchange and currency system and practice, and upon the position of the Indian note-issue, and to consider whether, in the light of this experience and of possible future variations in the price of silver, any modifications of system or practice may be required, to make recommendations as to such modifications, and generally as to the policy that should be pursued with a view to meeting the requirements of trade, to maintain a satisfactory circulation and to ensuring a stable exchange standard.' The Committee submitted their report on 22 December 1919 and Government issued in February 1920 several notifications in order to give effect to their main recommendations. The official exchange value of the rupee was now raised to 2*s. gold* which was then different from 2*s. sterling,* as the English *paper* pound had not returned to its pre-War parity with gold ; in other words, the rupee was declared to be equivalent to 11.30016 grains of fine gold. It was further announced that Council Drafts and telegraphic transfers would be sold weekly by open tender at competitive rates, with a minimum rate which would vary with the cost in *sterling* of shipping gold to India so long as sterling was not equivalent to gold, and that in future Reverse Councils would be sold in India during periods of exchange weakness at a rate based on the cost of shipping gold from India to the United Kingdom.

2. The policy of maintaining a 2*s*. gold rate would, even in the most favourable circumstances, have proved a difficult, if not an impossible, task and circumstances at the time when the new policy was put into force were anything but favourable. In January 1920 a change in India's balance of trade had become evident and exchange had fallen below 2*s*. 4*d*., the level of December 1919. There were other abnormal circumstances at work which should have made the then Finance Member shrink from this policy. His predecessor had warned the Council in his last budget speech that there was at that time 'evidence of a considerable accumulation of funds, seeking temporary investment in India in preference to remittance to England', funds which 'any threat of a fall in exchange would bring out for remittance purposes'. It was also a matter of common knowledge in commercial circles that the more rash type of Indian merchant had placed heavy orders for imported goods of every kind and that when these goods would arrive in India, there would be a heavy demand for remittance to London. As ill-luck would have it, just when this new policy was decided upon, the London-New York exchange appreciably weakened and *sterling* fell in terms of *gold*. The result was that the rise in the rupee-*sterling* rate required to give practical effect to the Committee's recommendations was far steeper than the Babington Smith Committee could have anticipated. Moreover the *normal* parity of exchange as determined by Professor Cassel's formulæ was roughly only 1*s*. 4*d*. *gold* in March 1920, the purchasing power of both the Indian rupee and the American dollar in terms of commodities having fallen to a trifle less than half of what it was in 1913-4. But unmindful of these warnings, Government persisted in their policy, and attempted to influence the exchange rate by the sale of a limited amount of Reverse Councils at rates based on the American cross-rate, in the belief

that the balance of trade would soon swing back in India's favour. But the tide had really turned the other way, and owing to various causes the normal tendency to a favourable balance of trade was being completely reversed. Imports had increased owing partly to the increased demand for piece-goods, the stock of which had run low at the end of the War, and partly to the stimulating effect of the rise in exchange on demand. Exports, on the other hand, had declined owing to a combination of adverse circumstances. In the first place, Japan, one of the chief buyers of Indian *cotton,* was obliged to reduce her purchases because of a financial crisis there. Secondly, the demand for jute, hides and tea fell off, partly because of the large stocks accumulated in England and elsewhere, and partly because of the industrial uncertainty prevalent in the markets for these goods. Thirdly, India lost some of her best customers. Owing to various economic and political troubles, the countries of central Europe were not then in a position to pay for what they wished to purchase; to use the words of the then Prime Minister, they were 'like a starving man in rags looking through a shop window at commodities which he badly needs but for which he has not the money to pay'. In the United States, the deliberate action taken by the Federal Reserve banks to check speculative trading and to lead the way to a lower level of prices, tended to reduce American purchases of India's products. All these circumstances combined to reverse the normal tendency to a favourable balance of trade. The extent of the change may be realized by comparing India's trade returns for August 1919 with those for August 1920. Imports in the former period amounted to 16 crores and exports to 27, leaving a net balance of 11 crores in India's favour. In August 1920, however, imports jumped up to 31 crores, and the exports fell off to 20 crores, thus producing an unfavourable balance of 11 crores.

	In crores of rupees		Excess of exports over imports and of imports over exports
	Imports	Exports	
1920			
April	22	28	6
May	24	28	4
June	26	23	-- 3
July	28	21	— 7
August	31	20	—11
September	29	21	— 8
October	32	21	—11
November	32	19	—13
December	32	20	—12
1921			
January	31	19	—12
February	25	18	— 7
March	24	18	— 6
Total ...	336	256	—80

The monthly figures of private exports and imports of merchandise, given in the table above, show that the adverse balance of trade began in June and was greatest during the period from October to January.

In these circumstances, Government's efforts to enforce the new policy by selling Reverse Councils was bound to fail. To make matters worse, the new policy was not even given a *fair* trial. The essential idea underlying the sale of Reverse Councils is not so much to provide sterling remittance for the public as to *lock up the local currency and to reduce the volume of circulation* in India. But the Indian Government had not the courage to face the unpleasant consequences of a drastic reduction of the circulation. They did not withdraw notes from circulation to the full extent of the Reverse Councils sold ; they practically went on issuing new currency simultaneously with the sale of Reverse Councils. The price-level in

India as compared with the external price-levels thus remained practically as high as before ; and even on the theory on which the practice of selling Reverse Councils was based, the rupee-sterling exchange could not be raised in these circumstances. The only result of the persistence in the sale of Reverse Councils was a loss of about thirty-five crores to India.

The Finance Member's action evoked a storm of protest in the country, and was the subject of a debate in the Imperial Legislative Council. The non-official members attacked the Government policy on four different grounds. Firstly, that the sale of Reverse Council Bills was justified only when it was required to adjust the trade balance against India and that this contingency had not arisen at that time. Secondly, that it was unwise to draw on the Indian reserve in London under the conditions then existing, as there were no inflated treasury balances with the Secretary of State, no gold in the Gold Standard Reserve, and very little of it in the Paper Currency Reserve. Thirdly, that the course followed was very dangerous as it artificially encouraged export of British capital invested in India. And, lastly, it was urged that the transfer of capital put a strain on the money-market, reduced the value of Government securities, and raised the rate of interest at a time of the year when money was required to move the exports. The Finance Member in reply contended that his policy was 'an effort in fact to maintain exchange as near as possible to the *gold point,* that as there was a genuine demand for remittance on the part of companies for the purchase of machinery over and above remittances to pay for imports, it was exceedingly difficult to separate the speculative from the genuine demand for remittance, and that in case the Reverse Councils were withdrawn entirely we should have neither a gold standard, nor a gold-exchange standard, nor any kind of standard at all'.

In fairness to the Finance Member, it must be admitted that so far as the *principle* of selling Reverse Council Bills is concerned, he had practically no alternative if he was to make an effort to maintain the gold-exchange standard at all. But that did not justify his alarm at drastic *deflation,* nor the *rate* at which he sold the sterling drafts. In fact he himself was forced to admit that the difference between the market rate of exchange and the official rate at which Reverse Councils were sold incited 'people to make their remittances to England as quickly as possible, rather than spread them out throughout the year, as they would otherwise have done', and promised in the end to take steps to bring the two rates together. The truth is, that the gold-exchange standard had broken down under the stress of abnormal circumstances in the post-War period, and it was futile to make any effort to maintain it in the most unfavourable circumstances.

3. The adverse balance of trade prevailed almost throughout the year 1920 ; nor did the following year bring any change for the better. Both the external and internal factors in 1921 were unfavourable to Indian exchange. In spite of satisfactory rains, prices of wheat and other foodstuffs remained at record heights, and it was not found possible, except in the case of Burma rice, to relax the existing control over export. Labour troubles at the collieries curtailed the raising of coal and Indian railways were obliged to purchase foreign coal at greatly enhanced prices. The external conditions were likewise adverse. There was a progressive deterioration in the economic and currency position of the greater part of Europe, and little progress was made with the various schemes for providing credit for impoverished countries. The fall of prices in England, and the depression in Russia and central Europe, aggravated by famine conditions in the former country, deprived India of her best customers,

and Indian exports, which had reached their height with 31 crores in March 1920, declined to 18 crores in March 1921, and reached their lowest point in June 1921 with 16 crores. 'The most serious falling-off was in the exports of yarns and textile fabrics, which were 26 crores less than those of the previous year; the jute industry suffered the worst, exports of gunny bags totalling only 13,92 lakhs as compared with the previous year's total of 23,91 lakhs, and export of gunny cloth being valued at 15,92 lakhs as compared with 28,54 lakhs.' The net result for the year was that imports exceeded exports by 23 crores, as compared with 79 crores in the previous year. The table given below, taken from the *Report of the Controller of Currency,*

	Average of the five pre-War years ending 1913-4	Average of the five War years ending 1918-9	1919-20	1920-1	1921-2
	(lakhs of rupees)				
Balance of trade in merchandise (private)	+78,27	+76,34	+1,25,99	−79,26	−22,82
Balance of transactions in treasure (private)	−36,07	−10,80	− 10,82	+ 1,36	−12,17
Balance of remittances of funds	−42,62	−30,14	− 19,85	+27,76	+ 1,26
Total visible balance of account	− 42	+35,40	+ 95,32	−50,14	−33,73

1921-2, compares India's visible balance of account during the three years 1919-20, 1920-1 and 1921-2 with the average of the five years preceding the War and of the five years of the War.

The course of relative prices was even more unfavourable to Indian exchange during the two years 1920 and 1921, as is clearly brought out by the table given overleaf.[1]

[1] See *Hilton Young Commission Report,* Appendix 7.

	Price index number			Rate of exchange of Calcutta on London on the 1st of the month			
	Great Britain[1] (1913 parity)	United States[2] (1913 parity)	India[3] (July 1914 parity)	Sterling		Gold	
				s.	d.	s.	d.
1920							
January ...	289	233	201 (annual average)	2	$3\frac{7}{8}$	1	10
February ...	303	232		2	$8\frac{1}{2}$	1	$11\frac{7}{32}$
March ...	310	234		2	7	1	$9\frac{23}{32}$
April ...	306	245		2	4	1	$10\frac{1}{4}$
May ...	305	247		2	$3\frac{1}{4}$	1	$9\frac{7}{16}$
June ...	291	243		2	$1\frac{1}{4}$	1	$8\frac{3}{8}$
July ...	293	241		1	$8\frac{3}{4}$	1	$4\frac{7}{8}$
August ...	288	231		1	$10\frac{5}{8}$	1	$5\frac{5}{16}$
September ...	284	226		1	$10\frac{1}{4}$	1	$4\frac{5}{16}$
October ...	266	211		1	$9\frac{3}{8}$	1	$3\frac{17}{32}$
November ...	246	196		1	$7\frac{3}{8}$	1	$1\frac{11}{16}$
December ...	220	179		1	$6\frac{3}{8}$	1	$1\frac{3}{16}$
1921							
January ...	209	170	178 (annual average)	1	$5\frac{1}{4}$	1	$0\frac{15}{32}$
February ...	192	160		1	$4\frac{1}{4}$	1	$1\frac{1}{8}$
March ...	189	155		1	$3\frac{3}{8}$	1	$0\frac{3}{8}$
April ...	183	148		1	$3\frac{5}{8}$	1	$0\frac{9}{16}$
May ...	182	145		1	$3\frac{21}{32}$	1	$0\frac{23}{32}$
June ...	179	142		1	$3\frac{1}{4}$	1	$0\frac{1}{4}$
July ...	178	141		1	$3\frac{5}{16}$	0	$11\frac{23}{32}$
August ...	179	142		1	$3\frac{13}{32}$	0	$11\frac{9}{32}$
September ...	183	141		1	$4\frac{11}{16}$	1	$0\frac{13}{16}$
October ...	170	142		1	$5\frac{3}{8}$	1	$1\frac{3}{8}$
November ...	166	141		1	$4\frac{1}{2}$	1	$1\frac{5}{16}$
December ...	162	140		1	$3\frac{7}{8}$	1	$1\frac{5}{32}$

These figures show that both the sterling as well as the gold value of the rupee was at its highest in the early part of 1920 when prices in Great Britain and the United States were relatively to India at a very high level. After April 1920 prices continued

[1] *Economist* index number.
[2] United States Bureau of Labour index number.
[3] Revised index number of wholesale prices in Calcutta given in the *Indian Trade Journal*.

to fall rapidly in both the United Kingdom and the United States, and in the absence of a corresponding fall in Indian prices, the sterling value of the rupee fell from 2*s.* 8½*d.* in February to 1*s.* 5¼*d.* in December, while its *gold* value declined from 1*s.* 11$\frac{7}{32}$*d.* in February to 1*s.* 1$\frac{3}{16}$*d.* in December 1920. Government attempted to meet the situation by contracting currency to the extent of 31 crores 58 lakhs in the year 1920-1, but this proved insufficient to check the downward fall of the rupee. World prices continued to fall in 1921-2, the English index number falling from 220 in December 1920 to 162 in December 1921, and the American registering a fall of as many as 39 points during the same period. Events moved somewhat differently in India. From 1920 to 1921 the Indian price-level fell only 11 per cent owing to very feeble attempts by Government to contract the circulation. The rupee, therefore, failed to retain the full relative advantage in respect of purchasing power which it had established with reference to gold and sterling during the great rise in world prices that occurred towards the close of the War and continued during the post-Armistice period ; and the rupee-sterling rate fell below 1*s.* 4*d.* *sterling* during the months of March to September while the *gold* value of the rupee went below even 1*s.* *gold* during the months of June and July 1921.

4. Trade conditions were more favourable to Indian exchange in 1922-3. The year marked a distinct advance towards trade recovery. The monsoon was exceptionally favourable and the harvest excellent and although the unsettlement in the Near East following the Greek reverses in Asia Minor, the removal of Russia from the sphere of the world's commerce, and the failure to reach a satisfactory settlement of the reparations question and the consequent occupation of the Ruhr valley by France acted as impediments to a full trade recovery, the

	Price index number			Rate of exchange			
	Great Britain[1] (1913 parity)	United States[2] (1913 parity)	India[3] (July 1914 parity)	Sterling		Gold	
1922				s.	d.	s.	d.
January ...	159	138	175	1	$3\frac{15}{16}$	1	$1\frac{25}{32}$
February ...	158	141	176	1	$3\frac{5}{8}$	1	$1\frac{23}{32}$
March ...	160	142	180	1	$3\frac{3}{16}$	1	$1\frac{27}{32}$
April ...	159	143	180	1	$3\frac{3}{16}$	1	$1\frac{21}{32}$
May ...	162	148	182	1	$3\frac{5}{32}$	1	$1\frac{25}{32}$
June ...	163	150	178	1	$3\frac{11}{16}$	1	$2\frac{3}{8}$
July ...	163	155	176	1	$3\frac{5}{8}$	1	$2\frac{3}{16}$
August ...	158	155	173	1	$3\frac{21}{32}$	1	$2\frac{5}{16}$
September ...	156	153	172	1	$3\frac{17}{32}$	1	$2\frac{7}{32}$
October ...	158	154	172	1	$3\frac{9}{16}$	1	$2\frac{7}{32}$
November ...	159	156	174	1	$3\frac{21}{32}$	1	$2\frac{11}{32}$
December ...	158	156	172	1	$3\frac{31}{32}$	1	$2\frac{7}{32}$
1923							
January ...	160	156	175	1	$4\frac{1}{32}$	1	$3\frac{9}{32}$
February ...	163	157	176	1	$4\frac{5}{16}$	1	$3\frac{5}{8}$
March ...	163	159	177	1	$4\frac{5}{32}$	1	$3\frac{5}{8}$

5. The trade returns of 1923-4 showed a slow but sound and steady revival of trade. During the twelve months ending 31 March 1924, exports exceeded imports by about 145 crores, as compared with 90 crores in 1922 and an adverse balance of 21 crores in 1921. The balance of trade in merchandise and treasure was during this year in favour of India to the extent of 96.23 crores as against 29.76 crores in 1922 and an adverse balance of 33 crores in 1921. As to relative price-levels in India and England, the Calcutta index number of wholesale prices remained steady up to March 1924, being at 175 in January 1923 and 174 in December 1923 as well as in March 1924, while the *Economist* index number of prices in the United

[1] *Economist* index number.
[2] United States Bureau of Labour index number.
[3] Revised index numbers given in the *Indian Trade Journal*.

Kingdom, which stood at 165 in April 1923, declined to 155 in August, and rose to 170 in December, and to 172 in March 1924. The index number of the United States, however, fell from 156 and 159 in January and March 1923, to 151 in December 1923 and 150 in March 1924. Under these conditions, while the sterling value of the rupee showed on the whole an upward tendency, the *gold* value of the rupee tended to *decline*, as will be seen from the following table of the monthly average rates of telegraphic transfers from Calcutta and Bombay on London.

	Price index number			Rate of exchange			
	Great Britain (1913 parity)	United States (1913 parity)	India (July 1914 parity)	Sterling		Gold	
				s.	*d.*	*s.*	*d.*
1923							
January ...	160	156	175	1	$4\frac{1}{32}$	1	$3\frac{9}{32}$
February ...	163	157	176	1	$4\frac{5}{16}$	1	$3\frac{5}{8}$
March ...	163	159	177	1	$4\frac{5}{32}$	1	$3\frac{5}{8}$
April ...	165	159	173	1	$4\frac{1}{16}$	1	$3\frac{13}{32}$
May ...	164	156	169	1	$4\frac{3}{16}$	1	$3\frac{7}{16}$
June ...	160	153	170	1	$4\frac{1}{16}$	1	$3\frac{5}{16}$
July ...	155	151	166	1	$4\frac{3}{32}$	1	$3\frac{1}{8}$
August ...	155	150	167	1	$4\frac{1}{32}$	1	$3\frac{1}{16}$
September ...	160	154	169	1	$4\frac{1}{32}$	1	3
October ...	160	153	169	1	$4\frac{5}{32}$	1	$3\frac{3}{32}$
November ...	169	152	172	1	$4\frac{11}{16}$	1	$3\frac{3}{8}$
December ...	170	151	174	1	$5\frac{7}{32}$	1	$3\frac{3}{8}$
1924							
January ...	173	151	170	1	$5\frac{5}{32}$	1	$3\frac{1}{16}$
February ...	173	152	173	1	$5\frac{1}{8}$	1	$3\frac{5}{16}$
March ...	172	150	174	1	$4\frac{1}{2}$	1	$2\frac{9}{16}$

6. The changes in the Paper Currency Reserve have already been noticed in chapter III. The composition of the Gold Standard Reserve during the period under review is indicated by the table given overleaf.

	31 March 1921	31 March 1922	31 March 1923	31 March 1924		
In England	£	£	£	£	s.	d.
Estimated value of sterling securities (as per details below)	38,951,416	40,140,132	40,043,831	39,999,058	10	9
Cash at the Bank of England ...	4,883	1,775	3,658	941	9	3
Total ...	38,956,299	40,141,907	40,047,489	40,000,000	0	0
Details of Investment						
1. British Treasury Bills	24,559,000	28,839.000	30,955,000	23,695,000	0	0
2. Exchequer 5¾ per cent Bonds 1925 ...	2,663,700	...	2,250,000	3,275,000	0	0
3. ,, ,, ,, ,, 1921 ...	6.955,800	...		...		
4. National 5 per cent War Bonds ...	3,414,000	6,414,000 (1922) 2,750,000 (1923)	3,606,000 (1924) 500,000 (1925) 725,000 (1928) 75,000 (1929)	6,780,000	0	0
5. Treasury 5 and 5½ per cent Bonds 1927-30	...	...	...	4,100,000	0	0
6. Treasury 5 and 5½ per cent War Bonds 1925	...	...	...	690,000	0	0
7. Guaranteed 2¾ per cent Stock ...	438,720	438,720	438,720	438,720	9	8
8. National War Loan 5 per cent Stock 1929-47	...	...	567,601	567,600	14	2
9. War Loan 3½ per cent 1925-8 Stock ...	...	...	...	150,000	0	0
10. 2½ per cent Consolidated Stock ...	1,000,000	1,000,000	...	...		
11. Transvaal Government 3 per cent Guaranteed Stock 1923-5	1,092,023	1.092,023	...	...		
12. Union of South Africa Bills 1925 ...	...	129,000	700,000	...		
Total numerical value ...	40,123,243	40,662,743	39,817,321	39,606,321	3	10

CHAPTER IX

INDIAN CURRENCY AND EXCHANGE, 1924-31

1. The monsoon of 1924 was a satisfactory one, giving the country very good harvests, exceptional agricultural prosperity, and a large surplus of agricultural products for export. The world demand for this surplus was large in the aggregate and exports established a new record. Partly on account of the high level of prices of imported commodities and partly on account of the superior attraction of cheap gold and silver, imports of merchandise were comparatively small, and the *balance of trade in merchandise* exceeded the previous year's record, amounting in the aggregate to 155.18 crores. The net import of gold during the year amounted to 73.78 crores, that is very nearly double the net imports in 1922-3, the previous record year. The gross and net imports of silver exceeded those of the preceding year by over 2 crores and $1\frac{1}{3}$ crores respectively. In spite of this exceptionally heavy import of bullion, the total *visible balance of trade* in favour of India amounted to 61.06 crores.[1] The influence of relative price-levels was likewise favourable to Indian exchange. Between December 1923 and September 1924 prices in the United States and India remained fairly stable, the American index falling only two points and the Calcutta index remaining the same, namely 174, both at the beginning and at the end of this period. The English index number, however, rose from 170 in December 1923 to 176 in September 1924. In these circumstances the rupee-sterling exchange rose steadily during the first half of the year, touching 1*s.* $5\frac{23}{32}$*d.* in October, then equivalent to about 1*s.* $4\frac{1}{4}$*d.* in *gold,* despite heavy remittance

[1] See *Report of the Controller of Currency* (1924-5).

operations by Government. From September 1924 gold prices in the United States began to rise, the index number being 149 in September and 157 in December, and 161 in March 1925.[1] Sterling prices too moved upward between September and December and the tendency to a sharp upward movement of exchange became so great that Government decided to make an effort to prevent exchange from breaking away materially above 1*s.* 6*d.* In pursuance of this policy, Government expanded currency in various ways. The system of purchasing sterling in India instead of selling Council Bills in London was greatly extended. During the greater part of the preceding year Council Bills had been offered by tender once a week in London and purchases of sterling had replaced the sale of intermediate bills by the Secretary of State. In 1924-5, the purchase of sterling in India became the main method of remittance to the Secretary of State. Altogether, a sum of £7,579,000 or Rs. 10,09,00,000 was remitted by sale of Council Bills in London as against £33,191,000 or Rs. 45,29,98,000 remitted by the purchase of sterling in India.[2] During the busy season from October to March, the note-issue was expanded to the extent of 8 crores against internal bills of exchange and 6 crores against British Treasury Bills and in order to provide ample margin for possible expansion in the future, the maximum limit of fiduciary issue was raised by the Indian Paper Currency (Amendment) Act 1925 from 85 to 100 crores. But while the expansion of currency was sufficient to maintain the value of the rupee in the neighbourhood of 1*s.* 6*d.* sterling, it was hopelessly inadequate to prevent it from rising above 1*s.* 4*d.* gold. So abnormally large was the volume of trade, that Indian prices tended to *fall in spite* of the limited expansion of currency, the Calcutta

[1] See *Hilton Young Commission Report,* Appendix 7.
[2] See *Report of the Controller of Currency* (1924-5), para. 11.

index coming down from 176 in October 1924 to 162 in March 1925. The *gold* value of the rupee was thus allowed to rise to 1*s.* $4\frac{13}{16}$*d.* in November and 1*s.* $5\frac{3}{16}$*d.* in December 1924, to 1*s.* $5\frac{21}{32}$*d.* in January and to 1*s.* $5\frac{17}{32}$*d.* in March 1925.

It is important to remember these broad facts in view of the bitter controversy that arose over the ratio question. Had the Indian Government decided to manipulate currency by *expanding* it as much as was required to prevent the rupee from rising above 1*s.* 4*d.* gold, they could easily have done so during this period. But the Indian officials in charge of the currency were habituated to judging the needs of the situation more by the trend of sterling prices, which tended to fall between October 1924 and March 1925,[1] than by the course of dollar prices which continued to rise up to the end of the year.[2] They were more anxious to *peg* the rupee to *sterling* in the neighbourhood of 1*s.* 6*d.* than to link it with *gold* at the rate of 1*s.* 4*d.*[3]

2. In 1925-6, the monsoon, though not uniformly satisfactory was, on the whole, favourable, and a good harvest produced a large exportable surplus. Private exports of Indian merchandise were valued at 374.86 crores, a decrease of about 10 crores from the previous year's figure, and re-exports of foreign merchandise at 10.49 crores, a decrease of about three crores from the previous year. The value of private imports of merchandise, on the other hand, decreased from 243.16 crores in 1924-5 to 224.11 crores in 1925-6. The balance of trade in merchandise was thus in favour of India to the extent of 161.24 crores. Imports of bullion showed a large decline from the abnormal figures of the previous year and the total visible balance of trade amounted to over 109 crores, that is

[1] From 180 in October 1924 to 174 in March 1925.
[2] From 145 in June 1924 to 161 in March 1925.
[3] For further discussion of this point, see my *Studies in Indian Currency and Exchange*, ch. vii.

only 6 crores less than that of 1919-20, the previous record year.[1] As to the price movements during the year ending 31 March 1926, there was practically no change in the *relative* price-levels in the United States and in India, the American index number falling from 161 in March 1925 to 152 in March 1926 against a fall of ten points in the Calcutta index from 162 to 151 during the same twelve months. Sterling prices fell more than either the American or the Indian but this was due to the fact that sterling prices had not been completely adjusted to gold prices in the United States in April 1925, when England returned to gold. In these circumstances, the exchange-market came to be dominated by Government remittances during the year. No Council Bills were offered at any time during the year, but large purchases of sterling were made in India, especially between September and February, in order to steady exchange. Thus exchange during the year was practically stabilized at 1*s.* 6*d.* as the rate never fell below the lower gold point and was effectively prevented from rising above the upper gold point by Government purchases of sterling. The highest and lowest quotations for telegraphic transfers on London in each month of the year are given below.[2]

	Highest		Lowest	
1925	*s.*	*d.*	*s.*	*d.*
April	1	$5\frac{7}{8}$	1	$5\frac{13}{16}$
May	1	6	1	$5\frac{13}{16}$
June	1	$6\frac{3}{32}$	1	$5\frac{31}{32}$
July	1	$6\frac{3}{32}$	1	$6\frac{1}{16}$
August	1	$6\frac{1}{8}$	1	$6\frac{3}{32}$
September	1	$6\frac{5}{32}$	1	$6\frac{1}{8}$
October	1	$6\frac{5}{32}$	1	$6\frac{5}{32}$
November	1	$6\frac{5}{32}$	1	$6\frac{1}{8}$
December	1	$6\frac{5}{32}$	1	$6\frac{5}{32}$

[1] See *Report of the Controller of Currency* (1925-6).
[2] Ibid., para. 9.

	Highest		Lowest	
1926	s.	d.	s.	d.
January	1	$6\frac{5}{32}$	1	$6\frac{5}{32}$
February	1	$6\frac{5}{32}$	1	$6\frac{1}{8}$
March	1	$6\frac{1}{8}$	1	$5\frac{15}{16}$

3. Trade conditions were less favourable to Indian exchange in 1926-7. As compared with the previous year, private exports of Indian merchandise decreased in value to the extent of 73 crores while re-exports declined by $2\frac{1}{2}$ crores owing mainly to a heavy drop in the world prices of the main export staples of India, cotton, jute, grains and seeds. Imports of private merchandise, on the other hand, increased in value from 224 crores to 230 crores. The balance of trade in merchandise came down to only 79.29 crores as against 155.01 crores in 1924-5 and 161.13 crores in 1925-6. There was a drop of 13 crores in the imports of bullion with the result that the total visible balance of trade was in favour of India to the extent of 39.96 crores, the corresponding figure for the previous year being 109.25 crores. To make matters worse, the comparatively high price of gilt-edged securities in India stimulated transfer of funds to London for the purpose of investment in sterling securities, a tendency which was increased by the speculative chance of capital appreciation in the event of a fall in exchange. The course of world prices continued to be downward, the American index number falling from 152 in March 1926 to 145.3 in March 1927. In these circumstances, the rate of Indian exchange could only be maintained in the neighbourhood of 1*s.* 6*d.* (1) by reducing considerably the purchase of sterling, (2) by selling sterling to the extent of £1,425,000 between 1 and 9 December, and (3) by contracting currency to the extent of $9\frac{1}{2}$ crores (net).

Judged by the results achieved, Government were entirely successful in the object they had in view. Prices fell in India, but the variation of prices was far less than in the two preceding years. Whereas the general index number for wholesale prices in Calcutta, as quoted in the *Indian Trade Journal,* fluctuated between 176 and 162 in 1924-5 and 164 and 151 in 1925-6, variations of 14 and 13 points respectively, during the year 1926-7 there was a variation of 5 points only, between 151 and 146, and the rupee-sterling exchange remained throughout in the neighbourhood of a 1*s.* 6*d.* rate, as can easily be seen from the following quotations for telegraphic transfers on London in each month of the year.[1]

	Highest		Lowest	
1926	*s.*	*d.*	*s.*	*d.*
April	1	$5\frac{29}{32}$	1	$5\frac{25}{32}$
May	1	6	1	$5\frac{27}{32}$
June	1	$5\frac{15}{16}$	1	$5\frac{7}{8}$
July	1	$5\frac{29}{32}$	1	$5\frac{27}{32}$
August	1	6	1	$5\frac{29}{32}$
September	1	$5\frac{31}{32}$	1	$5\frac{15}{16}$
October	1	$5\frac{29}{32}$	1	$5\frac{13}{16}$
November	1	$5\frac{27}{32}$	1	$5\frac{3}{4}$
December	1	$6\frac{1}{32}$	1	$5\frac{31}{32}$
1927				
January	1	$6\frac{1}{32}$	1	$5\frac{31}{32}$
February	1	$5\frac{31}{32}$	1	$5\frac{7}{8}$
March	1	$5\frac{31}{32}$	1	$5\frac{27}{32}$

4. Among other questions, the question of the permanent rate at which the rupee-sterling exchange should be stabilized came up for consideration before the Hilton Young Commission, who submitted their report in August 1926. The majority of the

[1] *Report of the Controller of Currency* (1926-7).

Commissioners recommended that the rupee should be stabilized in relation to *gold* at a rate corresponding to an exchange rate of 1*s.* 6*d.* for the rupee, on the ground that at that rate prices in India had already attained a substantial measure of adjustment with those in the world at large. The available statistics showed (1) that during the eighteen months from December 1922 to June 1924, when the rupee was worth about 1*s.* 3*d.* gold, the rupee price-level ranged round a mean of about 176, (2) that in the succeeding year, while the rupee was rising to 1*s.* 6*d.* gold, the rupee price-level fell below 160, and (3) that from then, while the rupee had remained, or been held, at about 1*s.* 6*d.* gold, the rupee price-level had ranged round a mean of about 158 with a tendency to fall in sympathy with world prices, which were approximately the same at the beginning of period (1) and at the end of period (3). It appeared legitimate to the majority of the Commissioners, therefore, to conclude that during the period of change there had been a mutual adjustment of prices and exchange, and that a substantial equilibrium had been attained about the middle of 1925 and had been maintained from then.[1] They found in the steadiness of exchange a further indication of equilibrium between internal and external prices during the previous twelve months. Exchange being the mechanism by which differences in the external and internal price-levels were adjusted, when exchange remained steady over a fairly long period, they considered it safe to infer that there were no differences to be adjusted. It appeared to them wrong to argue that exchange had been kept at 1*s.* 6*d.* only by Government manipulation, because in fact the so-called manipulation had been confined to an addition of 9 crores to the note circulation during the previous busy season and a withdrawal of 8 crores at the end of it—an amount contemplated by the Indian Paper

[1] *Hilton Young Commission Report*, para. 183.

Currency Act as a normal seasonal variation.[1] The foreign trade of the country, taken as a whole, had shown no signs of the imposition of any special handicap on either exports or imports, as would have been inevitable in the case of lack of equilibrium between internal and external prices.[2] These facts all pointed, in their opinion, to a substantial adjustment of prices during the twelve months of the 1*s.* 6*d.* rate of exchange[3] and any lowering of the rate which had prevailed so long would therefore mean a difficult period of re-adjustment, involving widespread economic disturbance,[4] producing a concealed reduction of wages,[5] and rendering inequitable all short-term contracts, which form the great bulk of contractual obligations incurred under modern conditions and which originated, for the most part, when conditions were based on the 1*s.* 6*d.* rate or in any event after exchange had broken away from 1*s.* 4*d.*[6] In these circumstances, they thought that the least disturbance would be caused, and the least injury would be done to all interests concerned by adhering to the *de facto* rate of 1*s.* 6*d.*

In order to give immediate effect to this recommendation of the majority of the Commission, as well as to take the first steps for eventually linking the rupee to gold instead of to sterling as was unanimously recommended by the Commission, a new Currency Act was passed in the spring session of 1927, which received the assent of the Governor-General on 26 March 1927 and came into force from 1 April 1927. Under this Act, the English sovereign and half-sovereign ceased to be legal tender in India and an obligation was imposed on Government to purchase at the rate of Rs. 21-3-10 per tola of fine gold, all gold in the form of bars containing not less than 40 tolas, which might

[1] *Hilton Young Commission Report*, para. 189.
[2] Ibid., para. 190. [3] Ibid., para. 191. [4] Ibid., para. 176.
[5] Ibid., para. 193. [6] Ibid., para. 195.

be presented by the public at the Bombay mint, and to *sell* gold or, *at the option of Government, sterling* for immediate delivery in London at the same price after allowing for the normal cost of transport from Bombay to London, subject to the proviso that no person should be entitled to demand an amount of gold or sterling of less value than that of 1,065 tolas (400 ozs.) of fine gold. In other words, the Act fixed the parity of the rupee at 1*s.* 6*d.* or 8.4751 grains of gold, and aimed at confining the variations of Indian exchange within the narrow limits of gold export and import points.

5. Circumstances in 1927-8 were quite favourable to this policy. The monsoon of the year was exceptionally good, and the export of private merchandise amounted to 319 crores, an increase of about 17½ crores in comparison with the previous year. The value of private imports of merchandise rose from 230 crores in 1926-7 to nearly 247 crores in 1927-8 but this was partly counterbalanced by a decrease of over 7 crores in the net import of bullion. The visible balance of trade in favour of India was thus about 49.7 crores as against 40 crores in the previous year. Relative price-levels were not unfavourable to Indian exchange ; the English Board of Trade index number rose from 140 in April 1927 to 141 in March 1928, while the Calcutta index number declined from 145 in April 1927 to 144 in March 1928. The net result of these factors was greater strength in exchange, which nearly reached the upper gold point in December and January, and a large increase in the volume of remittances by Government.

In the very beginning of the year, Government introduced the system of *purchase of sterling* in India by *public* tender. Every week, on the appointed day, usually Wednesday, tenders were received simultaneously in Calcutta, Bombay, Madras and Karachi, and on the following day particulars

of the amounts allotted at each rate were published in each of these places. Between the days on which tenders were received, intermediates were offered at the Imperial Bank at a rate usually $\frac{1}{32}d.$ above the highest rate accepted on the preceding Wednesday. The total amount of sterling thus purchased amounted to Rs. 37.77 crores at an average rate of 1*s.* 5.997*d.* The highest and lowest quotations for telegraphic transfers on London for each month of the year were as given below.[1]

	Highest		Lowest	
1927	*s.*	*d.*	*s.*	*d.*
April	1	$7\frac{7}{8}$	1	$5\frac{13}{16}$
May	1	$5\frac{15}{16}$	1	$5\frac{13}{16}$
June	1	$5\frac{29}{32}$	1	$5\frac{27}{32}$
July	1	$5\frac{27}{32}$	1	$5\frac{13}{16}$
August	1	$5\frac{7}{8}$	1	$5\frac{15}{16}$
September	1	$5\frac{15}{16}$	1	$5\frac{7}{8}$
October	1	$5\frac{15}{16}$	1	$5\frac{29}{32}$
November	1	6	1	$5\frac{15}{16}$
December	1	$6\frac{3}{32}$	1	6
1928				
January	1	$6\frac{3}{32}$	1	$6\frac{1}{32}$
February	1	$6\frac{1}{32}$	1	$5\frac{15}{16}$
March	1	$5\frac{31}{32}$	1	$5\frac{15}{16}$

6. Trade conditions during 1928-9 were even more favourable to exchange. The value of imports increased, as compared with 1927-8, by over 4 crores and amounted to 251.42 crores, while the total exports, including re-exports, rose by 9 crores to 338 crores. The result was that the balance of trade in merchandise was in favour of India to the extent of 86.54 crores as against 81.96 crores in 1927-8 and 79.47 crores in 1926-7.

[1] *Report of the Controller of Currency* (1927-8).

Deducting the net imports of treasure, which amounted during the year to 34.36 crores as against 32.19 crores in the previous year, the total visible balance of trade was favourable to India to the extent of 52.18 crores as against 49.77 crores in 1927-8 and 40.14 crores in 1926-7.[1] Such a large favourable trade balance more than neutralized the slight latent tendency to weakening exchange due to a fall in the English index number[2] from 141 in March 1928 to 138 in February 1929. In fact the exchange was so strong as to encourage Government to sell Council Bills, purchase sterling and otherwise remit money to the United Kingdom to the extent of 41.02 crores as against 37.77 crores in 1927-8 and 2.82 crores in 1926-7. Even then, so large was the value of trade that the Calcutta index number of prices actually declined from 144 in March and 146 in April 1928 to 143 in March 1929. The weekly rates of telegraphic transfers on Calcutta during the twelve months ending 3 April 1929 were as given below.

1928					
April	...	4, 11, 18, 25	...	...	1*s.* $5\frac{31}{32}$*d.*
May	...	2, 9, 16, 23, 30	...	...	1*s.* $5\frac{11}{16}$*d.*
June	...	6, 13	...	...	1*s.* $5\frac{31}{32}$*d.*
,,	...	20	...	...	1*s.* $5\frac{7}{8}$*d.*
,,	...	27	...	...	1*s.* $5\frac{27}{32}$*d.*
July	...	4, 11, 18, 25	...	...	1*s.* $5\frac{7}{8}$*d.*
August	...	1, 8	...	...	1*s.* $5\frac{7}{8}$*d.*
,,	...	15	...	...	1*s.* 6*d.*
,,	...	22	...	...	1*s.* $5\frac{29}{32}$*d.*
,,		29	...	...	1*s.* $5\frac{15}{16}$*d.*
September	...	5, 12, 19	...	...	1*s.* $5\frac{31}{32}$*d.*
,,	...	26	...	...	1*s.* 6*d.*
October	...	3	...	...	1*s.* 6*d.*
,,	...	10, 17, 24	...	...	1*s.* $6\frac{1}{32}$*d.*
,,	...	31	...	...	1*s.* $6\frac{1}{16}$*d.*
November	...	7, 14	...	...	1*s.* $6\frac{1}{16}$*d.*
,,	...	21, 28	...	...	1*s.* $6\frac{1}{32}$*d.*

[1] See *Indian Trade Journal*, vol. XCIII, p. 263.
[2] Board of Trade.

1928				
December	... 5, 12, 19, 26	...	...	1*s.* $6\frac{1}{32}$*d.*
1929				
January	... 2	...	...	1*s.* $6\frac{1}{32}$*d.*
,,	... 9	...	...	1*s.* 6*d.*
,,	... 16	...	...	1*s.* $6\frac{1}{32}$*d.*
,,	... 23	...	...	1*s.* $6\frac{1}{16}$*d.*
,,	... 30	...	...	1*s.* $6\frac{1}{32}$*d.*
February	... 6	...	...	1*s.* $5\frac{31}{32}$*d.*
,,	... 13	...	...	1*s.* $5\frac{15}{16}$*d.*
,,	... 20, 27	...	...	1*s.* $5\frac{31}{32}$*d.*
March	... 6, 13, 20, 27	...	...	1*s.* $5\frac{31}{32}$*d.*
April	... 3	...	...	1*s.* $5\frac{31}{32}$*d.*

7. During the year 1929-30, the various factors affecting Indian exchange were, on the whole, less favourable than in the preceding year. Although the monsoon was adequate and well-distributed, and the staple crops good, the general depression in world trade, particularly the catastrophic fall in the world prices of agricultural produce and raw materials, led to a sharp decline in exports. Private exports of merchandise amounted in value to only 311 crores as against 330 crores in 1928-9, while re-exports were valued at 7.13 crores as against 7.83 crores in 1928-9. Fortunately, the value of private imports of merchandise decreased from 251.5 crores to 239, a fall of 12.5 crores, and the net imports of treasure declined from 34.36 crores in 1928-9 to 26.2 crores. Thus in spite of a substantial fall in exports, the total visible balance of trade was in favour of India to the extent of 52.82 crores as against 52.11 crores in 1928-9. This was not, however, adequate enough to neutralize the effect of a heavy fall in world prices. The index number of prices in England came down from 139 in April 1929 to 125 in March 1930 while that of the United States dropped from 97 in April 1929 to 91 in March 1930. There was, therefore, a tendency to a weakening exchange throughout the year and

Government were obliged to support exchange by contracting currency in various ways. The Imperial Bank repaid in April 2 crores, the balance of the amount borrowed by it under the Paper Currency Act, while Government contracted during the year 15.77 crores against sterling securities, 11.75 crores against rupee securities of the Government of India and 2.94 crores by small direct transfers of silver bullion for sale from time to time throughout the year up to November. The result was that the Calcutta index number of prices came down from 140 in April 1929 to 125 in March 1930.

The highest and lowest quotations for telegraphic transfers on London for each month of the year are given below.

	Highest		Lowest	
1929	*s.*	*d.*	*s.*	*d.*
April	1	$5\frac{31}{32}$	1	$5\frac{29}{32}$
May	1	$5\frac{29}{32}$	1	$5\frac{27}{32}$
June	1	$5\frac{7}{8}$	1	$5\frac{13}{16}$
July	1	$5\frac{13}{16}$	1	$5\frac{25}{32}$
August	1	$5\frac{27}{32}$	1	$5\frac{3}{4}$
September	1	$5\frac{27}{32}$	1	$5\frac{13}{16}$
October	1	$5\frac{27}{32}$	1	$5\frac{13}{16}$
November	1	$5\frac{7}{8}$	1	$5\frac{13}{16}$
December	1	$5\frac{29}{32}$	1	$5\frac{7}{8}$
1930				
January	1	$5\frac{15}{16}$	1	$5\frac{7}{8}$
February	1	$5\frac{7}{8}$	1	$5\frac{7}{8}$
March	1	$5\frac{27}{32}$	1	$5\frac{13}{16}$

8. The conditions affecting exchange were even worse in 1930-1. Exports of Indian merchandise on private account came down from 310.8 crores to 220.4 crores, that is approximately by 29 per cent. Re-exports also declined from 7.13 crores to 5.14 crores. Imports of foreign merchandise on private account fell by 31.5 per cent from 238.9 crores to

163.6 crores. The net imports of treasure amounted to 24.43 crores as against 26.2 crores in 1929-30 and 34.36 crores in 1928-9. Gold prices continued to fall, the English index number coming down from 124 in April 1930 to 106 in March 1931 and the American one from 91 in April 1930 to 75[1] in March 1931. To support exchange, Government continued to contract currency, the total contraction during the year amounting to 38.64 crores as against 32.41 crores in 1929-30, and the Indian price-level was brought down from 123 in April 1930 to 100 in March 1931. The highest and lowest quotations for telegraphic transfers on London for each month of the year were as given below.

	Highest		Lowest	
1930	s.	d.	s.	d.
April	1	$5\frac{13}{16}$	1	$5\frac{13}{16}$
May	1	$5\frac{13}{16}$	1	$5\frac{25}{32}$
June	1	$5\frac{13}{16}$	1	$5\frac{25}{32}$
July	1	$5\frac{13}{16}$	1	$5\frac{3}{4}$
August	1	$5\frac{25}{32}$	1	$5\frac{3}{4}$
September	1	$5\frac{25}{32}$	1	$5\frac{3}{4}$
October	1	$5\frac{13}{16}$	1	$5\frac{25}{32}$
November	1	$5\frac{25}{32}$	1	$5\frac{3}{4}$
December	1	$5\frac{3}{4}$	1	$5\frac{3}{4}$
1931				
January	1	$5\frac{3}{4}$	1	$5\frac{3}{4}$
February	1	$5\frac{3}{4}$	1	$5\frac{3}{4}$
March	1	$5\frac{3}{4}$	1	$5\frac{3}{4}$

9. The total value of the Gold Standard Reserve during the period 1924-31 remained practically unaltered but its composition varied from time to time as shown overleaf.

[1] 1926 = 100.

	In England			In India	
	Gold at the Bank of England	Cash at the Bank of England	Estimated value of British and Colonial Government securities	Gold in India	Total
		(Pounds sterling)			
31 March 1925	nil	3,186	39,996,814	nil	40,000,000
,, ,, 1926	,,	825	39,999,175	,,	,,
,, ,, 1927	1,730,134	183	38,269,683	,,	,,
,, ,, 1928	2,152,334	4,028	37,843,638	,,	,,
,, ,, 1929	2,152,334	3,042	37,844,624	,,	,,
,, ,, 1930	2,152,334	3,748	37,843,918	,,	,,
,, ,, 1931	2,152,334	1,085	31,599,381	6,247,200	,,
30 Sept. 1931	2,152,334	2,591	9,906,875	27,938,200	,,
31 Dec. 1931	2,152,334	3,220	10,168,246	27,676,200	,,

CHAPTER X

EXCHANGE AND CURRENCY IN 1931

1. The year 1931 brought no relief from the world-wide economic depression which began in the last quarter of 1929. The main factors affecting Indian exchange continued to be adverse during the first six months of the year. The total exports of merchandise during the period were valued at only 78.01 crores as against 125.14 crores and 160.46 crores during the corresponding months in 1930 and 1929 respectively. The imports of merchandise on private account declined to 65.89 crores from 86.66 crores in 1930 and 120 crores in 1929. The balance of transactions in treasure, however, improved to +1.22 crores as against −17.49 crores and −12.91 crores during the corresponding period in 1930 and 1929 respectively. The net result was that the total visible balance of trade amounted to +10.90 crores as against +20.99 crores and +27.55 crores during the first half year of 1930 and 1929 respectively.[1] World prices continued to fall, the United States index number of prices coming down from 108 in March to 100[2] in August and the English index number from 91.1[3] in March to 85.7 in August 1931. To make matters worse, complications in the London money-market in the three months July to September led to the recall of funds invested by London in Indian treasury bills. In spite of Government attempts to maintain exchange by contracting currency and so allowing the Calcutta index number of prices to fall from 100 in March to 92 in August, the rupee rate weakened to

[1] *Indian Finance,* November 14 1931.
[2] 74.5 in March and 70.2 in August if 1926 = 100.
[3] *Economist.* The Board of Trade index number was 105.9 in March and 99.5 in August.

the lower gold point, necessitating heavy sales of Reverse Councils in August and September. On 21 September England abandoned the gold standard and Government decided by executive action to link the rupee to sterling instead of gold. The actual movements of the rupee-sterling exchange (Calcutta on London) during these six months are shown below.

	Highest		Lowest	
1931	s.	d.	s.	d.
April	1	$5\frac{13}{16}$	1	$5\frac{25}{32}$
May	1	$5\frac{27}{32}$	1	$5\frac{13}{16}$
June	1	$5\frac{25}{32}$	1	$5\frac{3}{4}$
July	1	$5\frac{13}{16}$	1	$5\frac{3}{4}$
August	1	$5\frac{3}{4}$	1	$5\frac{3}{4}$
September	1	$5\frac{3}{4}$	1	$5\frac{3}{4}$

2. It is worth while at this stage to recall briefly the consequences that have ensued since April 1925 from linking the rupee to gold. In March 1925 the English index number of prices stood at 174, that of the United States at 161 and that of India at 162. In August 1931 the English index number fell to 85.7 and that of the United States to 100.3. The policy of linking the rupee to gold at a fixed parity necessitated a corresponding fall of Indian prices, by means of continuous deflation, from 159 in 1925 and 148 in 1927 to 91 in September 1931. The necessary contraction of currency amounted to 7.01 crores in 1925-6, 23.16 crores in 1926-7, 40.51 crores in 1929-30, 32.95 crores in 1930-1,[1] and 13.02 crores during the five months April to August of the year 1931-2.[2] The note circulation, which stood at 184.19

[1] See *Report of the Controller of Currency* (1930-1), statement 27.
[2] *Indian Finance*, 30 January 1932, p. 131.

crores on 31 March 1925 and at 184.13 crores on 31 March 1927, declined to 146 crores in September 1931.

It is easy to see how serious are the reactions of such a catastrophic fall in the general price-level on both national and international economy. A fall in prices of such a magnitude seriously upsets the economic relations between creditors and debtors, for the burden of debt increases with the fall in prices. Its reaction on different types of income is admirably summed up by the Macmillan Committee[1] as follows :

'(1) All incomes fixed in terms of money, such as interest on the National Debt, debentures and other fixed-interest securities, remain unaltered. Thus incomes derived from those sources are able to purchase an increased proportion of the national output at the lower price-level.....

'(2) Many other incomes, which are not contractual in the same way as is interest on the National Debt, are fixed by custom or by statute. In the latter category fall, for instance, many classes of pensions and unemployment relief. Unless and until measures are taken.....to alter these charges, the recipients benefit in the same way as do holders of contractual incomes.

'(3) The proportion of the national output which can be purchased by these classes of recipients being increased, the amount left for distribution between the remaining sections of the community is reduced, with the result that so long as salaries and wages are unchanged, the final residue available for profits is inadequate.

'(4) The attempt to effect an adjustment sets in motion a series of consequences making for acute trade depression and unemployment.

'(5) In the sphere of international debts also a large fall of prices greatly increases the real burden falling upon the debtor nations.'

[1] *Report*, para. 190.

Public finance is no less seriously affected. The revenue of the State tends to decrease in several directions. For instance, business depression in India tends to reduce the yield of income-tax and customs duties, to decrease the railway traffic and hence the railway earnings and to affect adversely the earnings from post and telegraph offices. The fall in prices increases the burden of land revenue and water rates and hence necessitates large remissions of taxation by the Provincial Governments. At the same time, Government find it impossible to reduce a certain proportion of their expenditure which is contractual, for example pensions and interest on debt, while retrenchment in other directions can only be partial, slow and gradual. The result is that the State must meet the situation by an increase in the level, or an extension of the field of taxation at a time when the public is least able to bear it. The social consequences of violent price changes are even more disastrous, for they raise delicate issues of equity between different classes of the community. In the international sphere they set up a severe tension between creditor and debtor nations. Altogether, the trouble is widespread and serious, and causes a series of conflicts between debtors and creditors, entrepreneurs and workers, peasants and tax-gatherers.[1]

3. On account of these serious consequences of a severe fall in prices, a number of people welcomed the abandonment of the gold standard in England, in the absence of international co-operation for stabilizing the value of gold. But while this step secured for India relief from the necessity of following the downward movement of gold prices, it did not confer on India freedom to follow the course best suited to her interests, for the rupee, though divorced from gold, continues to be linked to *sterling* by executive

[1] For further treatment of this topic see *Macmillan Committee Report*, ch. x.

action. The result is that the rupee has been fluctuating in terms of gold, while its *sterling* value has been maintained in the neighbourhood of 1*s.* 6*d.*, as the following table will show.

Date		In sterling		In gold	
1931		*s.*	*d.*	*s.*	*d.*
September 20	...	1	$5\frac{3}{4}$	1	5·75
,, 22	...	1	$5\frac{3}{4}$	1	3·37
,, 28	...	1	$5\frac{3}{4}$	1	2·05
October 5	...	1	$5\frac{3}{4}$	1	2·03
,, 12	...	1	$5\frac{3}{4}$	1	2·2
,, 19	...	1	$5\frac{3}{4}$	1	2·27
,, 26	...	1	6	1	2·14
November 2	...	1	6	1	2·14
,, 9	...	1	$6\frac{1}{16}$	1	2·13
,, 16	...	1	$6\frac{1}{8}$	1	2·12
,, 23	...	1	$6\frac{1}{8}$	1	1·89
,, 30	...	1	$6\frac{1}{16}$	1	0·53
December 8	...	1	$6\frac{1}{16}$	1	0·18
,, 15	...	1	$6\frac{9}{32}$	1	0·82
1932					
January 7	...	1	$6\frac{3}{16}$	1	0·93
,, 14	...	1	$6\frac{1}{16}$	1	0·54

It is interesting to note in this connexion that while the non-official opinion in India had been clamouring for a sixteen pence gold rupee during the preceding six years, the gold value of the rupee declined below this level immediately after the abandonment of the gold standard in England, and whereas in the first half of the year Government had to contract currency, they have been expanding it on a large scale by revival of *ad hoc* securities since

22 September 1931. Substantial changes have consequently taken place in the total volume of note circulation and the composition of the Paper Currency Reserve as can be easily seen by a glance at the figures given below.

	22 September 1931	22 February 1932
Gross notes in circulation	146·23 crores	180·42 crores
Reserve		
Coin and bullion—		
In India		
Silver coin	126·68	104·85
Gold bullion... ...	4·49	4·82
Silver bullion ...	5·86	7·74
In England	nil	nil
Total coin and bullion	137·03	117·41
Securities (purchase price)—		
In India (nominal value 10·32 crores and 62·27 crores respectively)	9·2	59·5
In England	nil	nil
Total securities	9·2	59·5
Grand total of the reserve	146·23	176·91
Internal bills of exchange held on account of Government under Section 20 of the Indian Paper Currency Act 1923	nil	3·5
Percentage of metallic reserve to circulation	93·7	65·08

4. As a result of these currency changes in England and in India, there has been an appreciable rise of prices in these countries since September 1931. Whereas the United States index number of prices fell from 103.3 in August to 98.3 in December,

the English Board of Trade index number rose from 99.5 in August to 105.8 in December while that of Calcutta registered a rise from 92 in August and 91 in September to 98 in December 1931 and 97 in January 1932. Thus the fall of prices in India, which was such a marked feature of the economic situation during the preceding six years, has not only been arrested but changed into an appreciable rise of prices since 22 September 1931.

5. Another interesting development arising from the divorce of the rupee from gold is the marked stimulus given to the export of gold from India. The rupee being linked to sterling and de-linked from gold, the price of gold in India has been fluctuating with the variations in the sterling-dollar cross rate. For some months prior to 21 September 1931, the ruling rate was Rs. 21-3-9 per tola but since that date it has been rising higher and higher till on some occasions it has exceeded even Rs. 30 per tola. This has stimulated the sale of gold, probably by people in distress, the burden of whose debt has increased during the last two years owing to the slump in prices of agricultural produce. The result has been a heavy flow of gold from the mofussil to the Indian ports and from the ports to oversea markets. The following figures indicate how substantial have been the quantities of gold exports from India since September 1931.

Month	Gold exports (lakhs)
1931	
September	29
October	9,05
November	8,57
December	17,76
1932	
January	9,27
February	7,57
March	6,88
	59,39

Average value of imports and exports of gold coin and bullion for every ten years from 1900-1 to 1924-5 and for each of the official years from 1925-6 to 1931-2[1]

	Imports			Exports			
	Bullion	Sovereigns and other British gold coin	Total	Bullion	Sovereigns and other British gold coin	Total	Net imports or exports Imports + Exports —
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Average of 1900-1 to 1904-5	5,72,18,318	9,34,97,221	15,07,15,539	4,85,71,823	3,97,99,942	8,83,71,765	+ 6,23,43,774
,, 1905-6 to 1909-10	9,65,96,452	7,83,64,043	17,49,60,495	3,34,76,990	2,40,30,440	5,75,07,430	+11,74,53,065
,, 1910-1 to 1914-5	13,49,74,977	16,42,39,395	29,92,14,372	3,07,89,183	1,50,03,372	4,57,92,555	+25,34,21,817
,, 1915-6 to 1919-20	14,94,65,235	4,70,19,473	19,64,84,708	4,91,96,247	1,31,45,685	6,23,41,932	+13,41,42,776
,, 1920-1 to 1924-5	28,54,42,004	7,90,80,246	36,45,22,250	6,99,52,231	74,74,737	7,74,26,968	+28,70,95,282
,, 1925-6	25,26,78,970	9,96,20,393	35,22,99,363	23,26,183	14,27,381	37,53,564	+34,85,45,799
,, 1926-7	13,86,46,145	5,63,65,857	19,50,12,002	4,91,792	5,14,762	10,06,554	+19,40,05,448
,, 1927-8	11,42,46,018	6,70,98,044	18,13,44,062	98,300	2,45,739	3,44,039	+18,10,00,023
,, 1928-9	11,81,68,903	9,40,20,789	21,21,89,692	1,05,457	97,257	2,02,714	+21,19,86,978
,, 1929-30	6,83,46,025	7,39,65,452	14,23,11,477	65,539	37,522	1,03,061	+14,22,08,396
,, 1930-1	6,31,40,997	6,93,25,456	13,24,66,453	49,29,307	5,031	49,34,338	+12,75,32,115
,, 1931-2	1,53,60,459	1,26,34,905	2,79,95,364	58,43,62,379	2,33,60,827	60,77,23,206	—57,97,27,842

[1] *Report of the Controller of Currency* (1931-2), statement 4.

This heavy export of gold from India is an unusual feature in the monetary history of the world. For centuries India has been regarded as the sink of precious metals, and gold imports into India as practically lost for the world's monetary purposes. Even in recent years, India has been importing substantial amounts of gold as the table on page 133 clearly shows. The unusual exports of gold since September 1931 are, therefore, an indication of a fundamental change in the monetary habits of the people of India.

6. The de-linking of the rupee from gold had a favourable effect both on India's trade balance and the rupee-sterling rate during the last six months of the year. Excluding treasure, the exports of private merchandise declined from 226.65 crores in 1930-1 to only 159.55 crores during 1931-2, while the imports fell from 163.61 crores to 125.69 crores during the same period. But owing to the stimulus to the export of gold, due to the fall in the gold value of the rupee, the balance of transactions in treasure was in favour of India to the extent of 55.64 crores with the result that the total visible balance of trade at the close of the year was in favour of India to the extent of 90.5 crores as compared with only 37.6 crores in 1930-1. The sterling value of the rupee likewise improved, there being nothing in the movements of relative price-levels[1] in India and the United Kingdom to offset the effect of a favourable balance of trade. As early as the end of October the rupee-sterling exchange reached 1*s.* $6\frac{1}{32}$*d.* and except for a temporary set-back in the latter half of November, this strength continued unabated until the close of the financial year. The highest and lowest quotations for telegraphic transfers on London for each of the last six months are shown overleaf.

[1] The Calcutta index number was 91 in September, 96 in October, 97 in November and 98 in December 1931, and 97 in January and February 1932. The English Board of Trade index stood at 99 in September 1931, 104 in October, 106 during November 1931 to January 1932, and 105 in February.

	Highest		Lowest	
1931	*s.*	*d.*	*s.*	*d.*
October	1	$6\frac{1}{32}$	1	$5\frac{3}{4}$
November	1	$6\frac{5}{32}$	1	$6\frac{1}{32}$
December	1	$6\frac{1}{8}$	1	$6\frac{1}{32}$
1932				
January	1	$6\frac{1}{8}$	1	$6\frac{1}{16}$
February	1	$6\frac{1}{8}$	1	$6\frac{3}{16}$
March	1	$6\frac{1}{8}$	1	$6\frac{3}{32}$

CHAPTER XI

THE MONEY-MARKET AND THE BANKING SYSTEM IN INDIA

1. We may now complete our review of the chief developments in our currency system by a brief notice of the money-market and the banking system of India.

The main constituents of this market are : (1) the numerous Indian private bankers, brokers and money-lenders known by a variety of names such as the mahajans, sahukars, banias, multanis, marwaris, chettys, nanavatis and shroffs ; (2) the Indian joint stock banks ; (3) the European exchange banks ; (4) the presidency banks or the Imperial Bank of India. The first two constitute what is generally termed as the Indian or native money-market and the last two are collectively known as the European money-market. As a matter of fact, this division is rather misleading. The Indian joint stock banks are modelled on severely British lines and have a much closer connexion with the exchange banks and the Imperial Bank than with the indigenous banker. The real distinction lies between the private Indian banker and the joint stock banks organized on European lines.

2. The indigenous private bankers have existed in India from time immemorial. Even to-day they play in the economy of India a much more important part than the more imposing organized joint stock banks. In many parts of India they are still the only means of banking assistance. They are to be found everywhere, in almost every village, town and city. Their business is generally a family concern and passes from one generation to another. Their firms have no share capital and are not

organized on the joint stock principle. In the mofussil they are known as sahukars, banias, or mahajans, while in the presidency towns and other large centres they are called shroffs. They generally combine trading with lending. Some of the shroffs in Bombay indulge in speculation in produce and in Government paper; the native bankers in Cawnpore trade in money, cotton, grain etc.; those at Delhi finance the goldsmiths and skilled workers and act both as jewellers and bankers.[1] The mofussil bania or the mahajan plays very often a quadruple role; he is the purchaser of rural produce, the local agent of some European mercantile firms, the village shopkeeper and the money-lender.[2] On the whole, some of these rural money-lenders render great services to the country. They finance the agriculturist, assist in the movement of crops to the consuming areas and to the ports, and act as distributing agencies for all kinds of goods. The indigenous bankers in the towns have usually no direct business relations with the ryot. They finance agriculture through local sahukars or money-lenders but they maintain a close personal touch with the trader and the small industrialist. Their main business is to advance loans on every kind of security, promissory notes, hundis, land, or jewellery, and to deal in hundis or internal bills of exchange. They discount or buy hundis offered by their local customers and cash those drawn upon them by their agents or firms well-known to them in other places. They sell hundis upon their agents or their friends in other centres to those who have to remit money to those places but they rarely deal in foreign bills. Although some of them accept deposits and open current accounts, they generally view this kind of business as a source of weakness rather than strength, and have not generally developed a system of payment by cheques. The bulk of the money they

[1] Rau, R., *Banking in India*, p. 137. [2] *Loc. cit.*

lend comes from family funds or deposits of personal friends and relations rather than deposits from the general public. The majority of them combine banking with some form of trade, and the capital employed by them in banking is not distinguished from that employed in their trade. Strictly speaking, then, their business is not banking but money-lending, for the trading capital of a typical bank comes not so much from its proprietors or its shareholders as from its depositors. Among the 'big five' in England, for instance, it has been found that there is held on the average about £40 of deposits for every £1 of shareholders' capital. It is not possible, however, to distinguish an Indian indigenous banker from a private money-lender by the fact that the latter receives deposits and deals with other people's money rather than with his own, as a number of money-lenders and even shopkeepers receive deposits to some extent without doing any other banking business, while a large number of persons known generally as bankers and shroffs and doing a substantial amount of business in hundis and remittance work do not receive any deposits except from members of their own families, friends and relatives.[1]

The town or the city shroff invests funds, his own or those deposited with him by other parties, in the purchase of traders' hundis and approaches banks for funds only in the last resort. The banks do not compete with him in this business, for the security on which he lends is not considered suitable by them. He is in intimate daily touch with his clients and has learnt by long experience and family connexions their exact standing, moral as well as financial. He can, therefore, lend merely on the basis of the borrower's *general* credit position without hypothecation of any particular assets as cover for the accommodation required. His requirements as to *security* are, therefore, much less rigid than those of the banks.

[1] *Central Areas Banking Inquiry Committee Report*, para. 196.

Moreover, under the existing conditions, it is difficult for banks to connect a trader's hundi or bill with any *particular* lot of goods or produce, as no sale contracts, invoices, or documents of title are usually tendered in support of hundis or bills. The result is that the hundi rate in the bazaar is determined entirely by the shroffs, so long as their own funds are sufficient to carry the traders' hundis.[1] Only in the busy season, when the supply of hundis exceeds the capacity of the shroffs to finance them, recourse is had to the banks. The traders' hundis are then endorsed by the shroffs on the approved list of banks and offered to them for discount. The endorsing shroff then becomes the connecting link between the smaller Indian private bankers and the organized banks in the country.

The Indian shroffs generally confine their financing operations to *internal* trade ; they rarely discount European paper, or purchase foreign or sterling bills. Neither do they lend money on Government paper or similar securities. The shroffs' demand for accommodation is therefore determined entirely by the conditions of internal trade and very often ceases if, owing to the activity of the export trade, the rates of the Imperial Bank and the exchange banks rise higher than eight per cent.[2]

3. Unlike the private bankers, the Indian joint stock banks, other than the Allahabad Bank and the Oudh Commercial Bank, have all been established in recent years. They are to be found distributed mostly in big commercial centres like Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore, Delhi and Cawnpore. They form a confusing group, as under the Indian Companies Act many small money-lending firms, which hardly do any banking business in the strict sense of the term, are registered as

[1] Gubbay, M. M. S., *Indigenous Banking in India*, pp. 13-4.
[2] J. H. Sleigh's letter (1898) reprinted as an appendix to the *Fowler Committee Report*.

banks. The official publications relating to banking statistics include only those which have a minimum paid up capital and reserves of one lakh of rupees, and since 1913 divide them into two classes, namely (1) those with a paid up capital and reserves of five lakhs of rupees and over, and (2) smaller banks with a paid up capital and reserves of between one and five lakhs. In 1913 the number of banks in class A was only 18 as against 23 in class B ; in 1929 the former increased to 33 as against 45 in class B. The average size of these banks is small compared with that of the banks in other progressive countries. At the end of 1929, only 9 of these 78 banks had deposits of more than one crore each, namely the Central Bank of India with 12.72 crores, the Allahabad Bank with 11.36 crores, the Bank of India with 11.17 crores, the Punjab National Bank with 5.38 crores, the Bank of Baroda with 5.74 crores, the Bank of Mysore with 1.94 crores, the Indian Bank, Madras with 1.87 crores, the People's Bank of Northern India[1] with 2.84 crores, and the Punjab and Sind Bank with 1.17 crores. The aggregate paid up capital and reserves of these 78 banks in 1929 amounted to 12.69 crores, their deposits to 66.30 crores, and their cash balances to 9.50 crores.

The main object of these Indian joint stock banks is to attract deposits of all kinds, current, savings and fixed. In the matter of advances, they discount local and inland bills, open cash credit accounts, and give loans against various kinds of securities, for example hypothecation of stock exchange securities, of agricultural produce in their godowns, or of goods and commodities like piece-goods, sundries, etc., and mortgages of properties. They remit money on behalf of their clients from one place to another, buy and sell shares and other stock exchange securities for the public, and do other agency and safe custody work. Some of them have branches in the

[1] Now in liquidation.

mofussil but their business is in the main almost confined to securing deposits for use at the presidency towns and the larger commercial centres. As a rule they do not do any foreign exchange business nor do they generally re-discount their bills or undertake the business of bank acceptances. The following table gives a general idea of their financial position since 1870.

Class A—Banks with capital and reserve of five lakhs of rupees and over

(1) Year	(2) Number of reporting banks	(3) Paid up capital	(4) Reserve and rest	(5) Total	(6) Deposits	(7) Cash balances	(8) Percentage of (7) to (6)
		(Rs. 1,000)					
1870	2	9,83	1,82	11,65	13,95	5,07	36·3
1880	3	18,00	3,11	21,11	63,37	16,63	26·4
1890	5	33,50	17,59	51,09	2,70,78	55,79	20·6
1900	9	82,12	45,60	1,27,72	8,07,52	1,19,04	14·7
1910	16	2,75,66	1,00,55	3,76,21	25,65,85	2,80,25	10·9
1913	18	2,31,33	1,32,94	3,64,27	22,59,19	4,00,17	18·6
1915	20	2,81,39	1,56,65	4,38,04	17,87,27	3,99,41	22·3
1918	19	4,36,45	1,65,59	6,02,04	40,59,48	9,48,58	23·3
1919	18	5,39,07	2,24,27	7,63,34	58,99,47	12,16,63	20·6
1920	25	8,37,02	2,55,46	10,92,48	71,14,64	16,30,70	22·9
1921	27	9,38,80	3,00,81	12,39,61	76,89,63	15,65,90	20·4
1922	27	8,02,24	2,61,65	10,63,89	61,63,86	12,03,88	19·5
1923	26	6,89,05	2,84,39	9,73,44	44,42,82	7,37,01	16·6
1924	29	6,90,55	3,80,39	10,70,94	52,50,52	11,29,70	21·5
1925	28	6,73,00	3,86,64	10,59,64	54,49,36	10,09,55	18·5
1926	28	6,76,34	4,08,05	10,84,39	59,68,02	9,11,64	15·3
1927	29	6,88,70	4,19,35	11,08,05	60,84,11	7,69,86	13
1928	28	6,74,84	4,34,66	11,09,50	62,85,36	8,19,00	13
1929	33	7,86,97	3,66,54	11,53,51	62,72,03	9,04,99	14

Class B—Banks with capital and reserve of over one lakh and less than five lakhs of rupees

(1) Year	(2) Number of reporting banks	(3) Paid up capital	(4) Reserve and rest	(5) Total	(6) Deposits	(7) Cash balance	(8) Percentage of (7) to (6)
		(Rs. 1,000)					
1913	23	39,14	11,35	50,49	1,51,15	24,95	16·5
1915	25	45,38	9,73	55,11	91,37	20,01	21·9
1918	28	48,65	14,43	63,08	1,55,35	36,90	23·75
1919	29	53,11	21,86	74,97	2,28,49	53,71	23·5
1920	33	61,42	19,95	81,37	2,33,46	41,91	17·95
1921	38	77,05	23,23	1,00,28	3,26,02	43,52	13·3
1922	41	83,00	27,65	1,10,65	3,37,89	56,02	16·6
1923	43	81,14	30,20	1,11,34	3,26,50	61,47	18·8
1924	40	72,64	34,22	1,06,86	2,66,53	34,36	12·9
1925	46	80,79	37,70	1,19,49	3,41,40	67,89	19·9
1926	47	86,22	39,72	1,25,94	3,46,97	82,14	23·7
1927	48	84,95	37,25	1,22,20	3,45,58	52,23	15
1928	46	81,19[1]	38,68	1,19,87[1]	3,49,66	52,09	15
1929	45	74,94	40,08	1,15,02	3,57,51	44,95	13

The figures given below bring out clearly the cash position of each of the nine banks which have deposits of one crore and over.

	Year	(1) Total deposits	(2) Total cash and bullion	Percentage of (2) to (1)
		(Crores)		
The Central Bank of India, Bombay	1922	13·22	2·15	16·1
	1923	15·69	3·03	19·3
	1924	13·86	3·70	26·8
	1925	13·96	3·08	22·1
	1926	16·83	3·21	19·1
	1927	15·36	1·70	11·1
	1928	14·57	1·41	9·7
	1929	12·72	1·71[2]	13·4

[1] Revised.
[2] Includes money at call and short notice.

	Year	(1) Total deposits	(2) Total cash and bullion	Percentage of (2) to (1)
		(Crores)		
The Allahabad Bank, Calcutta	1922	11·04	2·71	24·5
	1923	Not available		
	1924	9·25	2·19	23·7
	1925	9·45	1·48	15·5
	1926	10·06	1·61	16
	1927	10·27	1·43	13·9
	1928	11·19	1·59	14·2
	1929	11·37	1·83	16
The Bank of India, Bombay	1922	10·01	1·86	18·6
	1923	9·68	1·98	20·5
	1924	9·51	2·30	24·2
	1925	10·20	2·42	23·7
	1926	9·89	1·47	14·8
	1927	10·31	1·50	14·5
	1928	11·07	1·75	15·8
	1929	11·17	1·92	17·1
The Punjab National Bank, Lahore	1922	4·72	1·04	21·1
	1923	5·43	·59	10·9
	1924	6·26	·82	13·1
	1925	7·04	·94	13·4
	1926	7·85	·61	7·8
	1927	7·32	·57	7·7
	1928	7·28	·89	12·2
	1929	5·38	·36	6·6
The Bank of Baroda, Baroda	1922	4·77	·77	16·1
	1923	5·20	·87	16·7
	1924	4·82	·85	17·6
	1925	5·38	·93	17·4
	1926	5·63	1·01	19·7
	1927	5·51	·92	16·7
	1928	5·60	·87	15·5
	1929	5·74	·82	14·3

	Year	(1) Total deposits	(2) Total cash and bullion	Percentage of (2) to (1)
		(Crores)		
The Bank of Mysore, Bangalore	1922	1·59	·40	25·1
	1923	1·41	·19	13·5
	1924	1·39	·28	20·1
	1925	1·30	·17	13·1
	1926	1·45	·19	13·1
	1927	1·80	·17	9·4
	1928	2·04	·23	11·3
	1929	1·94	·25	12·9
The Indian Bank, Madras	1922	·63	·08	12·7
	1923	·68	·08	11·8
	1924	·76	·06	7·9
	1925	·99	·16	16·2
	1926	1·13	·23	20·3
	1927	1·44	·12	8·3
	1928	1·58	·26	16·4
	1929	1·86	·39	20·9
The People's Bank of Northern India,[1] Lahore	1927	1·82	·26	14·3
	1928	2·62	·36	13·7
	1929	2·84	·48	16·9
The Punjab and Sind Bank	1928	1·08	·15	12·2
	1929	1·17	·16	13·6

Among the other banks, quite a large number have been content with cash reserves of even less than twelve per cent in recent years, as the following table will show.

[1] Now in liquidation.

Class A

Name of the bank	Percentage of cash reserves to deposits							
	1922	1923	1924	1925	1926	1927	1928	1929
Benares Bank, Benares ...	11·7	8·5	11·7	11·1	13·7	14·4	10·8	9·1
Bengal National Bank, Calcutta	4·5	·6	7·1	4·8				
Canara Bank, Mangalore ...	*	1·7	·7	2·5	·8	1·2	3	13·5
Dawson's Bank, Pyapon ...	10·3	5·7	7·4	11·7	4·8	6·9	6·6	6·8
Industrial Bank of Western India, Ahmedabad ...	15·4	6·1	6·9	6·7	4·4	7·7	5	7·4
Karnani Industrial Bank, Calcutta ...	10·3	9·5	14·1	14·8	5·2	4·2	4·9	3·2
Mufassil Bank, Gorakhpur ...	11·6	8·3	4·6	5·3	4·2	5·4	2·2	2·2
Nedungadi Bank, Calicut	8·5	9·8	11·3	12·3	11·2	10·4	10·5	9·8
Punjab Co-operative Bank, Amritsar ...	16·5	11	13·1	5·5	6·7	5·4	3·8	4·5
Simla Banking and Industrial Banking Co., Simla ...	*	*	12·2	11·3	7·7	10·1	10·5	10·9

* For this year, this was under Class B.

Class B

Name of the bank	Percentage of cash reserves to deposits							
	1922	1923	1924	1925	1926	1927	1928	1929
Andhra Bank, Masulipatam					17·1	·9	4·8	11·1
Bank of Bihar, Patna ...				16·5	10·2	21·8	21·3	13·5
Bank of Upper Burma, Maymyo ...				4·1	15·6	17·2	11·7	17·1
Bari Doab Bank, Lahore ...	5·3	6·3	6·5	3·6	4·9	2·2	3·7	6·4
Bhargava Commercial Bank, Jubbulpore				16·6	28·4	17·6	9·03	10·1
Bhowanipore Banking Corporation, Calcutta ...	13·9	7·4	3·9	6·4	2·4	1·9	5	5·7
Calicut Bank, Calicut ...	4·9	5·2	4·7	13·5	3·8	7	4·9	6·6
Canara Banking Corporation, Udipi ...		2·4	2·6	3·8	7·1	5·9	2·5	2·7
Dharwar Bank, Dharwar ...			6	1·2	4·4	·9	·9	·6
Jotedar Banking and Trading Corporation, Jalpaiguri ...					4	9	1·2	6
Karachi Bank, Karachi ...	2·4	5·8	6·3	2·7	8·4	2·8		

Name of the bank	Percentage of cash reserves to deposits							
	1922	1923	1924	1925	1926	1927	1928	1929
Lyallpur Bank, Lyallpur ...				9·9	13·6	12·8	3·9	3·9
Pangal Nayak Bank, Udipi	1·7	·7	1·5	3·25	·6	3·1	·5	·4
Punjab Zamindars' Bank, Lyallpur ...			3·4	2·7	·7	1·7	1·2	1·7
Travancore National Bank, Tiruvala ...	2·6	4·8	5·3	6·2	5·5	7·7	7·3	6
Vellore Commercial Bank, Vellore ...	·7	·9		2·25	2·2			
Vellore Mercantile Bank, Vellore ...	35·2	·8	7·3	1·4	1·3	*	3·1	*

These figures disclose an exceedingly unsatisfactory state of affairs. Writing in 1913 with reference to the figures up to 1910, Mr. J. M. Keynes, the well-known English economist, drew pointed attention to the steady deterioration of the position, and the hopelessly inadequate cash balances of the Indian joint stock banks, and prophesied that some of the smaller banks would 'go down like ninepins' in the next bad times. The prophecy was literally fulfilled only a few months after he gave the warning. As many as 55 banks went into liquidation in the course of a single year 1913-4, 11 failed in 1915, and 13 in 1916. Owing to the failures of 1913-7, no less than 34 per cent of the total trade capital of the Indian joint stock banks

* Capital and reserve were less than one lakh of rupees.

disappeared. For a few years after the crisis of 1913, the banks pursued a more cautious policy and increased the ratio of cash reserves to deposits; but since 1920 they have been again allowing their cash balances to be lowered to a dangerous extent. During the three years 1922-4, as many as 53 joint stock banks failed, their total paid up capital being 477 lakhs and their subscribed capital 1046 lakhs. In 1927 and 1928 the banks in Class A reduced their cash balances to only 13 per cent of their deposit liabilities and those in Class B had cash balances to the extent of only 13.3 per cent in 1921, 12.9 per cent in 1924 and 13 per cent in 1929. Even some of the big banks have been guilty of this unsound practice. In 1928 the cash balances of the Central Bank of India amounted to only 9.7 of its deposits; those of the Punjab National Bank fell as low as 7.8 per cent of its deposits in 1926 and 6.6 per cent in 1929. In 1928 as many as ten banks in Class A and fifteen in Class B had less than twelve per cent cash reserves. Such low cash balances are inexcusable in a country where modern banking is yet in its infancy and where public confidence in banks is a matter of very tender growth. The crisis of 1913 has evidently taught no lessons to our Indian joint stock banks, for the present state of affairs is actually worse than the cash position of the banks during the years immediately preceding the banking crisis of 1913.

As a contrast, the table[1] below gives the percentage of cash in hand and money at call and notice to the total liabilities of the joint stock banks (excluding the Bank of England) in such a well-developed country as Great Britain.

1890	18·1	1914	27·6
1900	20·7	1916	28
1910	23	1917	28

[1] Taken from *The Economist*, 11 May 1929 and 14 May 1932.

1918	27·6	1926	21·1
1920	20·4	1927	22·6
1922	20·6	1928	21·1
1923	20·6	1929	21·5
1924	20·9	1930	20·9
1925	21·3	1931	20

4. The important part played by the exchange banks in the Indian exchange-market has already been described in chapter VI. Though originally established with a view to dealing in foreign exchange and to financing the foreign trade of India, the lack of general banking facilities in the country led them to take up also the ordinary internal banking business, till at the present time they have become a very important and powerful element in the general banking system of the country. In 1870 there were only three exchange banks ; in 1880, four ; in 1900, eight ; in 1910, eleven ; in 1920, fifteen ; and since 1922 there have been eighteen. These banks have their head offices located outside India and in fact represent various foreign financial interests, for example English, Japanese, German, American, etc. They fall easily into two groups, (1) banks doing a considerable portion of their business in India, and (2) banks which are agencies of large banking corporations doing a major portion of their business abroad. In their earlier years, the funds employed by them were drawn mostly from London, but in recent years they have been attracting an increasing volume of deposits in India. In 1870 their total Indian deposits amounted to only 52 lakhs of rupees ; in 1900 the figure rose to 10.5 crores ; in 1921 it jumped up to 75.2 crores ; while in 1929 it fell to 66.65 crores. Of the total deposits in Indian banks, the share of the exchange banks was as much as 32 per cent in 1929, while the Indian joint stock banks held only 31 per cent. The aggregate paid up capital and reserves for the eighteen exchange banks doing business in India in 1929 amounted to 228 million pounds, while their

Year	Number of banks	Capital and reserve			Deposits		Cash balances	
		Paid up capital	Reserve and rest	Total	Out of India	In India	Out of India	In India
		(£ 1,000)			(£ 1,000)	(Rs. 1,000)	(£ 1,000)	(Rs. 1,000)
1913	12	23,640	14,185	37,825	181,138	31,03,54	25,688	5,88,24
1914	11	22,885	14,157	37,042	164,970	30,14,76	40,694	8,39,37
1915	11	22,681	14,112	36,793	179,948	33,54,56	45,111	7,60,13
1916	10	22,836	15,095	37,931	208,232	38,03,88	41,367	10,14,01
1917	9	18,384	14,298	32,682	228,001	53,37,53	54,765	33,74,37
1918	10	22,269	17,180	39,449	305,937	61,85,60	57,981	15,17,55
1919	11	31,931	21,139	53,070	433,001	74,35,90	63,571	29,98,32
1920	15	54,198	36,019	90,217	513,671	74,80,71	84,197	25,17,53
1921	17	66,369	45,263	111,632	526,473	75,19,61	82,318	23,56,74
1922	18	66,541	45,680	112,221	527,348	73,38,44	81,654	16,17,63
1923	18	83,038	56,965	140,003	894,946	68,44,28	117,915	14,47,86
1924	18	72,538	57,926	130,464	844,682	70,63,48	114,648	16,36,69
1925	18	74,230	64,081	138,311	923,561	70,54,57	121,758	9,41,61
1926	18	77,413	70,590	148,003	969,886	71,54,22	136,286	10,72,84
1927	18	92,796	88,124	180,919	1,285,955	68,96,23	204,099	8,13,13
1928	18	95,803	92,120	187,923	1,358,774	71,13,86	236,621	8,05,57
1929	18	106,344	121,286	227,625	1,514,052	66,65,91	219,282	9,04,70

deposits and cash balances in India amounted to 50 million pounds and 7 million pounds respectively.

The table on page 150 gives us the main facts regarding the progress of these banks since 1913. These figures show that, while the exchange banks have been increasing their Indian deposits at a rapid rate in recent years, they have not cared to increase their cash balances in India to a corresponding degree. In 1913, Mr. J. M. Keynes, commenting on the figures then available, drew the serious attention of these banks to their dangerously low cash balances and observed : 'In the event of an internal financial crisis in India, the exchange banks are probably depending on the anticipation that they would be able to remit funds from London by telegraphic transfer. In this case they rely on not being hard pressed in India and in London at the same time. An Indian reserve, such as they appear to keep, of from eighteen to twenty per cent, would be respectable, for example, in England. But in such a country as India, where banking is ill-established and hoarding more than a memory, the proportion held in reserve seems somewhat lower than perhaps it ought to be. Possibly exchange banks have already been in smooth waters longer than is for their good. There are famous dates in the history of Indian banking which should serve as a *memento mori.*'[1] This grave warning of an acknowledged authority had its deserved effect for some eight years, but seems to have been conveniently forgotten since 1921. The following figures, giving the percentage of cash to liabilities on deposits of the exchange banks (calculated on their deposits and cash balances in India only), clearly show that the cash position has actually become worse in recent years than what it was when Mr. Keynes first sounded a note of alarm.

[1] *Indian Currency and Finance*, p. 216.

	1913	1915	1917	1919	1921	1922	1923	1924	1925	1926	1927	1928	1929
(1) Banks doing considerable portion of their business in India ...	19	19	40	35	28	19	19	20	13	14	11	11	15
(2) Banks which are merely agencies of large banking corporations doing the major portion of their business abroad ...	17	41	160	67	43	33	27	31	15	17	14	11	10

5. The presidency banks had a long history behind them. The Bank of Bengal was established as early as 1806 and the Bank of Madras was started in 1843. The first Bank of Bombay was opened in 1840 and dissolved in 1868 but a new Bank of Bombay was formed in the same year (1868). The history of these three banks in their relationship with Government falls easily into four well-defined stages. Prior to 1862 they enjoyed the privilege of issuing notes, but were directly controlled by Government and restricted in the scope of their business by their charters. The second period covers the years 1862 to 1876. In 1862 Government deprived them of the right of note-issue, but relaxed the old statutory limitations on their business and allowed them under certain agreements of that year to transact the paper currency business as agents of Government, to use Government balances free of interest, and to manage the treasury work at the centres where they

had branches. In 1866 the agreements were revised and the paper currency business was removed entirely from their control and placed under the direct management of Government. The third period dates from the Presidency Banks Act of 1876 which, amended slightly in 1879, 1899 and 1907, continued to govern them till the formation of the Imperial Bank. Under the provisions of this Act, these banks were confined to a fixed territory and had to work under severe restrictions as to the character of their business and the mode of its transaction. For instance, they could not (1) deal in exchange, (2) borrow or receive deposits payable out of India, or (3) lend money for a longer period than six months, or upon mortgage, or on the security of immovable property, or upon promissory notes bearing less than two independent names, or upon goods, unless the goods or the titles to them were deposited with them as security. At the same time Government abandoned all direct interference in their management, and the banks ceased to enjoy their full use of Government balances, reserve treasuries being constituted at the presidency towns in which the surplus revenues were drawn. They, however, continued to do a large amount of Government work, such as the management of the public debt and of the treasury work at the presidency towns and at their branches. This stage came to an end with the passing of the Imperial Bank of India Act in 1920.

In spite of the restrictions imposed upon these banks by Government from time to time, their business expanded at a fairly rapid rate. For instance, their total deposits rose from 6.4 crores in 1870 to 14.76 crores in 1890, to 32.34 crores in 1910, and to 76.18 crores in January 1921. They have become in fact the backbone of the internal banking system, being bankers for Government, and acting, to an increasing extent, as bankers' banks.

The following table gives an idea of the progress

made by the three presidency banks from 1880 to 1920.

Year	Paid up capital	Reserve and rest	Total	Deposits		Cash balances	Investments	Dividend for the year
				Government (Public)	Total			
	(lakhs of rupees)							
				Bank of Bengal				
1880	2,00	25	2,25	2,02	5,02	4,84	1,53	8½
1900	2,00	1,06	3,06	1,55	5,82	2,44	1,36	11
1913	2,00	1,91	3,91	3,01	1,825	8,41	3,10	14
1918	2,00	1,89	3,89	5,85	2,393	8,94	7,80	17
1920	2,00	2,10	4,10	4,34	34,74	12,21	9,11	19½
				Bank of Bombay				
1880	1,00	22	1,22	39	3,04	1,60	79	7½
1900	1,00	70	1,70	89	5,21	1,29	89	11
1913	1,00	1,06	2,06	2,01	12,19	4,78	2,29	14
1918	1,00	1,01	2,01	1,77	19,27	5,42	3,54	18½
1920	1,00	1,20	2,20	3,50	30,99	8,76	3,00	22
				Bank of Madras				
1880	50	7	57	49	80	98		
1900	60	24	84	37	2,73	1,31	67	8
1913	75	76	1,51	87	8,06	2,19	1,18	12
1918	75	55	1,30	1,02	9,54	2,71	1,40	12
1920	75	48	1,23	1,19	15,79	5,06	2,13	18

6. What part did these banks play in financing the internal trade of the country? They did at times make advances to Indian traders against produce or against Government and other approved securities hypothecated to them, but the form which their assistance to trade usually took was the purchase or

re-discount of internal bills of exchange, known as hundis. How this system actually worked is described briefly in the following extract from Appendix A to the report of the Babington Smith Committee :—

'The people with whom the bank deals directly are for the most part large shroffs of good standing in the principal cities. These men operate with their own capital and, generally speaking, it is only when they have laid out all their available capital in purchasing the hundis of other (and usually smaller) shroffs that they come to the presidency bank. The shroffs whose hundis the larger shroffs have purchased have probably also similarly financed other and still smaller shroffs or mahajans, and so on until we get down to the smallest flea of all, namely, the village bania, or grain dealer or goldsmith. For instance, shroff A at Amritsar may purchase a bill drawn by a grain dealer upon a Bombay merchant. A may endorse the bill and sell it to B, a large shroff at Lahore, who sells it to the presidency bank, who send it to their Bombay agency for collection. Or the bill may be a pure finance bill (generally known as a "hand" bill) as opposed to a "trade bill" drawn against produce.

'Speaking very generally, it may be said that the bank's real security in the matter of purchasing or re-discounting bills is the personal standing of the drawee or endorser or acceptor, and the bank has an elaborate and very efficient system of limits whereby the amount of bills discounted for each shroff is watched. Put very briefly, the system is as follows :—Shroff A is given in the bank's register a limit of, say, twenty lakhs, and at the same time the names of the drawers of the bill purchased from him by the bank are watched. The bank may have purchased from A, say, fifteen lakhs of bills, the drawers of which are B, C, D, E, etc. If it is observed that shroff A has been purchasing rather too many bills

from shroff D, who is of comparatively small standing, or about whom not much is known, A will be liable to be turned down, or if the fact has been noticed by the head office, the branch will at once be told to be careful.

'As already mentioned, hundis are of two kinds: pure finance bills, known as hand bills, and trade bills. The banks are much more particular as to the amount of the former that they discount for a shroff than the latter. This is not because they receive any documents on account of trade bills (their direct security is just as personal as in the case of hand bills), but because they know that, somewhere or other, produce or goods exist against the credit so created, that such goods must have been hypothecated to one or other of the shroffs whose names are on the bill, and that, if anything goes wrong, such shroff will be able to realize on the goods and so to reimburse the subsequent holders of the bill, to whom he is liable. In the case of hand bills, on the other hand, it is impossible to say definitely how far these represent a genuine trade demand or not.'

7. Until 1920 these three banks worked independently of one another. The arrangement was highly unsatisfactory from many points of view, the country having no central bank, such as existed in most of the other civilized countries of the world. There was no hope of any substantial increase in the number of branches so long as the policy of the presidency banks was governed by considerations of territorial limits and of profit and loss, rather than the general development of the country. There was then no institution of commanding position in the country to which the money-market could look forward for help and guidance in a time of crisis. The presidency banks were not strong enough for the task, while Government had no machinery to bring their reserves into normal connexions with banking. As Mr. Keynes put it, 'With no central reserve,

no elasticity of credit currency, hardly a re-discount market, and hardly a bank rate policy, with the growth of small and daring banks, great increase of deposits, and a community not habituated to banking and ready at the least alarm to revert to hoarding, even where it had been seemingly abandoned, there were to be found most elements of weakness and few elements of strength.'

Nor was this the only unsatisfactory feature in the situation. Government maintained what is technically called an 'Independent Treasury System'. It is difficult to define this exactly as there was nothing like it in European countries—it existed only in the United States, but even there it was in the main a currency rather than a banking institution. Omitting all complications of detail, the chief features of the Indian system were :—Firstly, the maintenance by Government of several reserve treasuries in the three presidency towns ; secondly, an intimate relation between the operations of the Government in the Currency Department and the movement of funds on trade account, as Government undertook the supply of currency and remittance of funds on wholesale lines throughout the country ; and thirdly, the tendency of the surplus treasury funds to be drawn up towards the treasuries at headquarters. As these treasuries were not a part of the general banking system of the country, there was no regular and normal means of getting rid of the funds thus locked up in the reserve treasuries. The only way to send back the currency into circulation was to give loans from the treasury balances. The executive government was thus invested with power to cause stringency or easiness in the money-market, and the country compelled to maintain two distinct reserves, the treasury reserves and the bankers' reserves, with no clearly defined relation between the two.

Lastly, the arrangements stood in the way of a more *elastic* system of note-issue. In the absence

of a strong central bank, the function of note-issue was wholly dissociated from that of banking in India. To discount bills was the function of banks but to supply additional currency was the business of the Currency Department. It was difficult to maintain equilibrium between the supply of notes and the demand for currency under such conditions.

One of the chief peculiarities of the Indian money-market was the enormous range for the normal seasonal fluctuations in the bank rate, because of the scarcity of cash in the busy season and superfluity of funds in the slack months. The high rate in the busy season was not at all an adequate inducement for importing funds from abroad, as the busy season did not last more than three months and the bank rate obtainable on the *average* of the whole year was not at all attractive. The only way to escape from the inconvenience of this high *maximum* rate was to devise some means *within the country* for expanding the currency in the busy season. One easy way of providing this was to lend money from the Government balances *on the security of trade bills* either through the agency of a bank or directly to the money-market. But Government were unwilling to adopt the former course, considering it unwise to transfer the management of Government balances to a *private* bank, while the latter would have taken their officials to a field wholly unfamiliar to them. A still more serious objection against entrusting such a task to a Government department was the likelihood of encouraging the money-market to rely exclusively upon the Government Currency Reserve for relief in times of stringency. 'Whenever the bank rate was very high, there would be a clamour that Government were not lending all they might.'[1]

8. The only satisfactory solution of these difficulties was to establish a central bank in India. The suggestion was an old one; it had been repeatedly

[1] J. M. Keynes.

pressed upon the attention of Government, and had been shown to be within the sphere of practical politics by two carefully prepared memoranda, one by Mr. Keynes the other by Sir Lionel Abraham, presented to the Chamberlain Commission. Under Mr. Keynes's scheme, the proposed central bank was to be a State bank, performing a variety of functions both in London and in India. Its London office was to be comparatively a small affair. It was not to compete with the exchange banks in their remittance business nor was it to have any direct dealings with the public. It was to deal only with the Secretary of State, the money-market, and other banks; to confine its business to (1) the sale to other banks of drafts and telegraphic transfers payable at its Indian offices; (2) the re-discount of sterling bills at the Bank of England; (3) the borrowing for short periods from the Bank of England; (4) the loaning of funds on the London money-market; (5) the replenishment of the Secretary of State's funds at the Bank of England; (6) the flotation of sterling loans on behalf of the Secretary of State; and possibly also (7) the management of the Secretary of State's sterling and rupee debt in London.

In India it was to have much wider functions. It was, in the first place, to take up all the functions which the presidency banks performed then, with some relaxation of the then existing restrictions. Secondly, it was to manage the note-issue and the Government debt in India. Thirdly, it was to hold all Government balances including those held in the reserve treasuries and in London, with the exception of two small reserves, one with the Government of India, the other with the Secretary of State. Lastly, it was to supply its *own* customers with sterling remittance and to re-discount sterling trade bills for other banks. It was not to be entrusted with (1) the management of the mint or (2) the custody of the Gold Standard Reserve.

Mr. Keynes dwelt at length on the advantages likely to result from the establishment of such a bank and summed them up as follows :—'There are first of all direct advantages to Government.....The chief of them may be enumerated :—

'(1) The existing "Independent Treasury System", by which, whenever the Government balances are swollen, deliberately or not, large sums are taken off the money-market, is done away with by the removal of the cause of this system, namely, the absence of a large public or semi-public institution with which large balances could be safely and properly deposited, together with the difficulty of employing civil servants in a policy of discretionary loans out of the balances.

'(2) The objections to holding large sums at loan for short periods in the London money-market are avoided.....

'(3) A bank, responsible for the management of the note-issue, has greater opportunities than are open to Government for pushing the circulation of notes and for popularizing them by an increase in the facilities available for convertibility.

'(4) The responsibility of Government officials for a variety of financial and semi-financial business is greatly reduced by handing over to a bank all questions of balances, note-issues, remittances, and loans on the London market.

'(5) The Government have at their command the services of officers of the highest position, trained in financial and banking business instead of civil servants who, however full of adaptability and intelligence, have been selected and trained mainly for other purposes.

'(6) A buffer is placed between the Secretary of State and vexatious criticism on small details of financial business.

'Next come the immediate advantages to the business world :—

'(1) In addition to the partial release of Government balances through their deposit in a central institution, a considerable amount of funds is made available by the reform of the note-issue.

'(2) The present wide fluctuations of the bank rate and its normal high level in the busy season may be somewhat moderated.

'(3) The increase of branches, which the union of Government and banking business should promote, would gradually bring sound banking facilities to many parts of India where they are now almost entirely wanting, both directly and by supplying a basis, in reliance on which, private and co-operative banking could be built up.

'(4) The introduction of re-discount facilities, while probably not of the first importance in the immediate future, might greatly aid the eventual development of Indian banking on the most desirable lines which European experience has so far evolved.'

9. Notwithstanding the able advocacy of Mr. Keynes and the authoritative opinion of the Chamberlain Commission that the question deserved 'the careful and early consideration of the Secretary of State and of the Government of India', no step was taken in the matter till the year 1920, when an Act for amalgamating the presidency banks was passed. This was followed by an agreement for a period of ten years[1] between the Government and the amalgamated banks, signed on 27 January 1921. The amalgamation scheme was admittedly a half-measure; the new Imperial Bank differed materially from the one proposed by Mr. Keynes. It was not invested with any responsibility for note-issue, though the issue of notes against commercial bills up to the limit of twelve crores under the Paper Currency Amending Act of 1923 implied the utilization of the machinery of the Imperial Bank. It was

[1] Since extended.

not entrusted with the remittance business of the Secretary of State or given the power to borrow without security in London or accept deposits outside India for use in India, although it was given access to London by the establishment of a London office which could do business only of a special kind. Unlike the State bank proposed by Mr. Keynes, it was to be paid for its services in respect of public debt but would not share its profits with Government, though it would have the increased use of Government funds *free of interest*. Nor did its constitution provide for that degree of Government control which Mr. Keynes considered as an essential feature of a State bank.

It was, nevertheless, an important step in the direction of establishing a central bank in India, and was a material advance on the state of affairs which existed prior to amalgamation. We may therefore notice a few details of this amalgamation scheme.

(1) *Capital*—The capital of the new Imperial Bank has been provided partly by amalgamating the capital of the three presidency banks and partly by increasing its authorized capital from 375 lakhs to 1125 lakhs, of which 562½ lakhs or one-half was paid at the outset.

(2) *Constitution*—Its constitution provides for (*a*) a central board and (*b*) three local boards in the three presidency towns. The central board deals with matters of general policy such as the transfer of funds from one part of the country to another, fixation of the bank rate (which is to be uniform for the whole of India) and the publication of the weekly statement. Its composition is intended to secure representation of all important interests concerned, including Government, the local boards, the shareholders and the general public. It has a *small* managing committee of its own, to which it has authority to delegate almost all its functions. The central board has no fixed

and permanent location; its meetings being held at fixed intervals alternately in Calcutta and Bombay. If any local board is dissatisfied with the orders of the managing committee, it has a right to insist on a meeting of the central board. The local boards elected by the shareholders on the local register in the three presidency towns are intended to safeguard local interests and are possessed of large powers of autonomy. A general meeting of the shareholders of the Imperial Bank is held on the first Monday of August every year at such time and at such local head office of the bank as is from time to time be prescribed by the central board, at which meeting the central board submits to the shareholders a statement of the affairs of the bank made up to the preceding thirtieth day of June. The decisions at any of the meetings of the shareholders are binding on the bank so far as they are consistent with the provisions of the Act.

Government exercise control over the bank in several ways. They have power to issue instructions to the bank in respect of any matter which, in their opinion, vitally affects their financial policy or the safety of Government balances. They can appoint four governors to the central board of the bank. They appoint two managing governors, who are the chief executive officers at the head of the bank, after consideration of the recommendations of the central board of the bank. They are entitled to demand any information touching the affairs of the bank and to appoint such auditors as they think fit to examine and report on the accounts of the bank.[1]

(3) *Business*—Its business is generally to follow the lines of that of the old presidency banks, but certain restrictions which had proved inconvenient in practice have now been removed. For instance, the Act permits, for the first time, the constitution of a London office and the borrowing of money in

[1] *Indian Central Banking Inquiry Committee Report*, para. 35.

England for the purpose of the bank's business upon the security of the assets of the bank. It is now the sole banker of the Government, the reserve treasuries having been abolished. It does the treasury work of Government free of cost. Government no longer undertake to transfer money for the general public between any two places; the Imperial Bank does this remittance work at rates not exceeding those approved by the Controller of Currency. It retains in its hands the administration of the public debt work, and arranges in connexion with the encashment of notes to supply the public as far as possible with the form of currency they require. It has now a London office, but this is not to compete with the exchange banks in ordinary exchange business. It conducts business only on behalf of its own constituents and re-discounts bills for other banks.

(4) *New branches*—A statutory obligation was imposed on the bank to open within five years from the commencement of the Act not less than a hundred new branches, of which at least one-fourth were to be established at such places as the Government of India might direct.

10. Since 1921 considerable progress has been made by the amalgamated presidency banks or the Imperial Bank on the lines laid down in this scheme. The Imperial Bank has undoubtedly made a serious effort to spread banking facilities in different parts of India. Before the amalgamation of the three presidency banks, Bombay and Madras were the only two provinces in which there had been any considerable extension of branches, but since the formation of the Imperial Bank, special attention has been given to provinces where banking facilities are restricted.[1] Of the new branches, thirty-six are located in places where there was previously no other bank, while sixty-one of the remaining branches have been opened at places where there are

[1] *Report of the Controller of Currency* (1925-6), p. 21.

Government treasuries. The following statement[1] sums up the progress achieved in this respect in the various provinces.

Province	Number of branches in existence before January 1921	Number of branches opened since January 1921	Total
Bengal ...	6	9	15
Bihar and Orissa ...	1	8	9
Assam ...	nil	2	2
United Provinces ...	5	18	23
Punjab ...	2	17	19
North-West Frontier	nil	3	3
Burma ...	3	3	6
Bombay ...	14	9	23
Madras ...	18	15	33
Central Provinces ...	3	7	10
Minor provinces ...	1	2	3
Indian States ...	5	8	13
Ceylon ...	1	nil	1
Total ...	59	101	160

According to Sir Norman Murray, one of the managing governors of the Imperial Bank, there are seventy-five branches in all at which it does not compete with any other bank as against a hundred branches where it comes into competition with other banks.[2] Of the hundred new branches some are still in their infancy, about thirty-two are already remunerative, several others are quietly building up on quite healthy business and only a few show no prospect of ever being able to cover their overhead charges.[3]

[1] *Report of the Controller of Currency* (1926-7), p. 20.

[2] For the other side see *Hilton Young Commission Report*, Appendix 78, paras. 9-11 and also Minutes of Evidence, Qq 9581-2, 11846, 11854, 11877, 11883, 11892, 11913, 11933-41, 12066. For the bank's defence against the allegation that it competes unfairly with other banks read Minutes of Evidence, Qq. 7740-54.

[3] See Sir Norman Murray's evidence, op. cit., Q. 9649.

In addition to these branches, the Imperial Bank has opened twenty pay offices, subagencies and outstations, many of which are situated in cities in which there is a full branch and a few in small places where the amount of business is insufficient to warrant the opening of a full branch.[1]

Under a clause in the agreement between the Imperial Bank and the Government of India, the bank undertakes to give the public every facility for the transfer of money between its branches at rates not exceeding certain maximum rates fixed by the Controller of Currency. These rates were originally fixed at one anna per cent for transfers of amounts of Rs. 10,000 and over, and two annas per cent for amounts of Rs. 1,000 and over but less than Rs. 10,000. For amounts less than Rs. 1,000, the rates were left to the discretion of the bank. Since 1924, however, the rate for *banks* for amounts over Rs. 10,000 has been reduced to half an anna per cent. The figures (in lakhs of rupees) in the following tables of the demand drafts purchased and drafts and telegraphic transfers paid show that since 1926 there has been a serious decrease in the use, by the public, of the facilities offered by the bank.

Demand drafts purchased

Year	Bengal circle	Bombay circle	Madras circle	Total
1920, 2nd half year ...	14,21	4,39	12,58	31,18
1921, 1st ,, ,, ...	5,10	4,78	10,31	20,19
1921, 2nd ,, ,, ...	17,36	9,72	10,95	38,03
1922, 1st ,, ,, ...	9,65	9,50	13,29	32,44
1922, 2nd ,, ,, ...	18,98	11,00	11,75	41,73
1923, 1st ,, ,, ...	16,13	18,92	16,30	51,35
1923, 2nd ,, ,, ...	27,07	18,91	10,50	56,48
1924, 1st ,, ,, ...	23,66	28,66	18,30	70,62
1924, 2nd ,, ,, ...	33,54	17,84	12,55	63,93
1925, 1st ,, ,, ...	29,93	34,54	19,59	84,06
1925, 2nd ,, ,, ...	38,70	20,55	13,71	72,96

[1] *Report of the Controller of Currency* (1925-6), p. 21.

Year	Bengal circle	Bombay circle	Madras circle	Total
1926, 1st half year ...	23,57	27,38	15,37	66,32
1926, 2nd ,, ,, ...	28,95	15,98	12,29	57,22
1927, 1st ,, ,, ...	26,52	24,56	17,48	68,56
1927, 2nd ,, ,, ...	34,04	21,27	15,55	70,86
1928, 1st ,, ,, ...	31,48	30,21	21,55	83,24
1928, 2nd ,, ,, ...	34,10	22,09	16,30	72,49
1929, 1st ,, ,, ...	24,25	33,93	22,17	80,35
1929, 2nd ,, ,, ...	27,09	23,29	17,48	67,86
1930, 1st ,, ,, ...	23,34	23,89	13,92	61,15
1930, 2nd ,, ,, ...	20,39	14,51	10,74	45,64

Drafts and telegraphic transfers paid

	Bengal circle	Bombay circle	Madras circle	Total
1920, 2nd half year...	12,14	5,48	7,03	24,65
1921, 1st ,, ,, ...	16,95	16,71	9,31	42,97
1921, 2nd ,, ,, ...	17,42	17,15	8,82	43,39
1922, 1st ,, ,, ...	22,64	21,80	10,16	54,60
1922, 2nd ,, ,, ...	24,54	20,02	7,47	52,03
1923, 1st ,, ,, ...	22,34	26,38	9,39	58,11
1923, 2nd ,, ,, ...	22,80	25,03	9,30	57,13
1924, 1st ,, ,, ...	26,99	30,94	12,43	70,36
1924, 2nd ,, ,, ...	34,31	27,10	9,96	71,37
1925, 1st ,, ,, ...	38,57	35,74	11,62	85,93
1925, 2nd ,, ,, ...	45,53	30,93	11,55	88,01
1926, 1st ,, ,, ...	50,71	29,85	11,80	92,36
1926, 2nd ,, ,, ...	41,48	27,31	10,33	79,12
1927, 1st ,, ,, ...	38,79	29,36	11,14	79,29
1927, 2nd ,, ,, ...	37,36	29,41	9,80	76,57
1928, 1st ,, ,, ...	32,87	30,49	11,29	74,65
1928, 2nd ,, ,, ...	39,73	29,52	11,00	80,25
1929, 1st ,, ,, ...	38,31	38,15	13,94	90,40
1929, 2nd ,, ,, ...	34,18	31,14	11,62	76,94
1930, 1st ,, ,, ...	34,96	33,11	12,31	80,38
1930, 2nd ,, ,, ...	29,21	32,16	11,20	72,57

Since 1921, the Imperial Bank has become a banker to Government to a much greater extent than before. Its London office, which was started in January 1921, has taken over a portion of the business of

the Government of India which was previously in the hands of the Bank of England, namely the administration of the rupee debt in England and the current account of the High Commissioner for India. Internally, reserve treasuries have been abolished and with the increase in the number of the bank's branches, the amount of Government funds locked up in treasuries has been gradually decreased as shown below (in lakhs of rupees).

Balance at Government treasuries on the last day of the month[1]

	1922-3	1923-4	1924-5	1925-6	1926-7	1927-8	1928-9	1929-30	1930-1
April ...	4,51	3,93	3,16	3,03	2,53	2,44	2,13	2,56	2,61
May ...	3,97	3,75	2,91	2,63	2,45	2,29	2,15	2,46	2,43
June ...	4,27	3,39	3,03	2,62	2,52	2,37	2,20	3,19	2,17
July ...	4,23	3,28	2,81	2,48	2,38	2,14	2,29	2,28	2,10
August ...	3,81	3,19	2,71	2,26	2,29	2,18	2,11	3,03	2,38
September	3,50	3,31	2,75	2,35	2,32	2,07	2,37	2,73	1,96
October ...	3,54	3,22	2,69	2,56	2,33	2,06	2,41	2,19	2,08
November	3,54	3,10	2,59	2,63	2,30	2,21	2,64	2,42	2,07
December	3,45	3,12	2,69	2,42	2,43	2,16	2,29	2,21	2,07
January ...	3,82	3,21	2,92	2,67	2,42	2,35	2,48	2,45	2,33
February	3,91	3,13	2,89	2,68	2,64	2,25	3,05	2,89	2,81
March ...	5,44	4,21	4,29	3,69	3,26	3,13	3,59	3,64	3,80

In accordance with the agreement between Government and the Imperial Bank, Government are not to charge any interest on Government balances with the bank for a period of ten years.[2] How valuable to the bank these public deposits have actually proved may easily be gauged from the figures given overleaf.[3]

[1] See *Report of the Controller of Currency* (1930-1), statement 13.
[2] Since extended.
[3] See *Hilton Young Commission Report*, vol. III, p. 479 for figures up to 25 December 1925, *Indian Central Banking Inquiry Committee Report*, para. 39 for the years 1926-8, and *Indian Finance* for 1929, 1930, 1931 and 1932.

Date	Public deposits	Other deposits	Cash	Percentage of public deposits to cash	Percentage of public deposits to other deposits
	(lakhs of rupees)			(per cent)	
1921					
28 January	7,96	76,43	27,05	29·5	10·4
1 April	5,37	74,03	24,14	22·2	7·3
1 July	20,15	70,84	34,70	58	28·4
30 September	8,49	83,75	29,71	28·6	10·1
30 December	6,80	64,91	13,56	50·1	10·5
1922					
31 March	20,08	57,08	20,48	98	35·2
30 June	16,70	62,97	33,92	49·3	26·5
29 September	13,36	73,19	36,73	36·4	18·3
29 December	14,02	55,89	15,48	90·5	25·1
1923					
30 March	20,53	53,62	14,44	142·2	36·5
29 June	12,38	68,28	28,40	43·6	28·9
28 September	15,69	78,89	39,40	39·8	32·9
28 December	8,14	72,35	17,04	47·7	13·5
1924					
28 March	26,02	71,20	18,02	143	25·4
27 June	21,43	74,14	21,54	99·6	34·1
26 September	24,23	73,58	28,30	85·6	37·6
26 December	9,78	72,29	17,82	54·9	38·3
1925					
30 January	17,70	69,72	18,32	96·6	25·4
27 February	23,31	68,27	17,38	134	34·1
27 March	26,14	69,52	19,34	135	37·6
1 May	26,30	68,70	19,11	137·5	38·3
25 May	28,96	68,74	21,64	133·8	42·1
26 June	22,46	73,78	33,98	66·1	30·5
31 July	24,81	75,76	46,86	53	32·8
28 August	20,92	75,33	42,73	49	27·8
2 October	8,28	79,02	31,90	26·3	10·6
30 October	8,11	74,48	24,96	32·5	10·9
27 November	8,11	74,18	21,60	37·5	10·9

Date	Public deposits	Other deposits	Cash	Percentage of public deposits to cash	Percentage of public deposits to other deposits
	(lakhs of rupees)			(per cent)	
25 December 1925	5,28	73,45	16,82	32	7·3
31 ,, 1926	6,45	73,90	20,90	30·8	8·7
31 ,, 1927	7,20	72,07	10,89	66·1	9·9
31 ,, 1928	7,95	71,80	10,57	75·1	11·1
13 ,, 1929	8,43	69,30	16,39	51·4	12·2
3 January 1930	7,83	71,54	12,99	60	10·9
9 ,, 1931	8,75	73,93	11,49	76·1	11·8
1 ,, 1932	8,32	63,88	11,06	75·2	13

It will be noticed that, during four out of twelve months in 1925, public deposits exceeded the cash reserve of the bank and that on another occasion its proportion to cash was as high as 96.6 per cent. During the preceding year, in two out of four quarters it exceeded 99 per cent and on a third occasion it was as high as 85.6 per cent. In 1923 it went up in the first quarter to 142.2 per cent, while in 1922 it was over 90 per cent during two out of four quarters. Comparing these with the corresponding figures of the Bank of England during the period 1921-5, we find that except on one occasion, namely 16 March 1926, when it went up to 101.3 per cent, its percentage of public deposits to cash never exceeded 84.5 per cent; in 1921 it exceeded 80 per cent on two out of four occasions; in 1922 it was below 80 per cent throughout the year and below 45 per cent on two out of four occasions; in 1923 it was below 65 per cent throughout and below 55 per cent during half the year; in 1924 it was below 50 per cent during

three out of four quarters of the year; and in 1925 it was below 46 per cent during six out of twelve months and below 60 per cent during eleven months of the year.

The percentage of public deposits to other deposits of the Imperial Bank shows also a striking contrast with the corresponding figures of the Bank of England during the years 1921-5. In the case of the latter, the highest percentage of public deposits to other deposits during this period was only 18.3 per cent while, in the case of the former, it was as high as 42.1 per cent. During 1925 it exceeded 30 per cent for six months and 20 per cent for nine months in the case of the Imperial Bank, while the corresponding percentage for the Bank of England was below 16 per cent for the whole twelve months. In 1924 it was below 10 per cent during three out of four quarters of the year in the case of the latter, while it was above 25 per cent for the whole year and exceeded 34 per cent on three out of the four occasions in the case of the former. In 1923 the Bank of England percentage was never above 15 per cent, while that of the Imperial Bank was above 28 per cent on three out of four occasions. In 1922 the proportion of public to other deposits of the Bank of England was below 10 per cent for half the year, while that of the Imperial Bank never fell below 18 per cent. It is obvious that public deposits play a much larger part in the business of the Imperial Bank in India than in that of the Bank of England in Great Britain.

The ordinary returns of the Imperial Bank give no indication of the extent to which it has been functioning as a bankers' bank. The figures supplied to the Hilton Young Commission by one of its managing governors, however, show that its business as a bankers' bank has not been growing at the rate expected by the public:

	(in lakhs)			
	Bankers' balances		Bankers' borrowings	
	Highest	Lowest	Highest	Lowest
1921	37,51	17,51	2,86	12
1922	24,53	6,64	4,39	43
1923	23,31	4,65	6,18	26
1924	15,07	1,93	10,18	85
1925	13,37	1,92	5,88	54

The following later figures, supplied by the bank to the Indian Central Banking Inquiry Committee indicate, on the whole, a decline in the bankers' balances with the Imperial Bank of India.

Total bankers' balances with the Imperial Bank of India

Date		Exchange banks	Indian joint stock banks	Total
		(lakhs of rupees)		
31 March	1928	3,20	81	4,01
30 Sept.	1928	3,71	1,12	4,83
31 March	1929	3,28	81	4,09
30 Sept.	1929	2,02	90	2,92
31 March	1930	1,88	81	2,69
30 Sept.	1930	1,88	1,05	2,93

11. The specimen weekly return of the Imperial Bank given overleaf shows its financial resources and the nature of its business.

It will be seen that the subscribed capital of the bank is very much larger than its paid up capital, so that, if the bank wishes to extend its activities, it can call as much as Rs. 5,62,50,000 without any

The Imperial Bank return for the week ending 22 January 1932

Liabilities	Amount (Rs. 1,000)	Assets	Amount (Rs. 1,000)
(Subscribed capital Rs. 11,25,00,000)		Government securities	23,71,15
Capital paid up	5,62,50	Other authorized securities under the Act	2,48,61
Reserve	5,00,00	Ways and means advances to the Government of India	5,50,00
Public deposits	9,61,22	Loans	8,92,36
Other deposits	61,02,65	Cash credits	25,55,87
Loans against securities per contra ...	nil	Inland bills discounted and purchased ...	5,25,53
		Foreign bills discounted and purchased...	17,32
Loans from the Government of India under Section 20 of the Paper Currency Act, against inland bills discounted and purchased per contra	2,50,00	Bullion	nil
		Dead stock	2,68,47
		Sundries	39,17
		Balances with other banks	37,87
Sundries	89,61	Cash	9,59,63
	84,65,98		84,65,98

difficulty. Moreover, the reserve built up out of the profits of past years is almost equal to the paid up capital and can be, and is, utilized in the business of the bank as if it were part of the share capital. Loans against securities per contra, which are shown as nil in this balance sheet, are usually borrowings of the bank against some of its authorized securities included in the assets side. Seasonal expansion of note-issue is responsible for the 'Loans from the Government of India under Section 20 of the Paper Currency Act' (see paras. 8 and 10 of chapter III).

On the assets side, it is significant that by far the largest item is cash credits, which differ from loans, the item third in importance, in so far that they are not fixed in amount but vary up to a stated maximum according to the demand of the borrower during the time for which he is given credit by the bank. These are generally running on demand and liable to be called up at any time.[1] The second item in order of importance consists of partly temporary loans to Government and partly the bank's investments in the Government of India loans and other securities authorized under the Act. Loans come next; these are advances to customers for fixed periods not exceeding six months under restrictions imposed by the Act. Discounting of bills, both inland and foreign, takes the fourth place; and of these, foreign bills represent only an insignificant quantity, as the Imperial Bank is not allowed to deal in foreign exchange except to a limited extent for its customers only. Cash refers to cash in hand available for immediate calls on account of deposits, loans, etc.; and dead stock represents buildings, furniture and movable property of the bank. It is clear that the activities of the bank are predominantly those of a *commercial* bank, being confined to granting short-period loans to trade and commerce.

[1] See Sir Norman Murray's evidence *Hilton Young Commission Report*, Minutes of Evidence, Q. 9600.

No separate figures are available for each year, showing the proportion of business done by the Imperial Bank with Europeans and Indians, but the following figures for the last week in March 1925, supplied to the Hilton Young Commission by Sir Norman Murray, tend to show that the charge of discrimination against Indian customers so commonly levied against the bank is not easy to sustain.

	Deposits	Percentage of total
Indian ...	Rs. 35,22 lakhs	67
European ...	Rs. 16,88 ,,	33

	Advances	Percentage of total
Indian ...	Rs. 48,27 lakhs	68
European ...	Rs. 23,18 ,,	32

Banks[1]

	Indian banks	Other banks
Deposits as on 27 March 1925 ...	Rs. 185 lakhs	Rs. 576 lakhs
Advances as on 27 March 1925 ...	Rs. 306 ,,	Rs. 223 ,,

NOTE—The advances to purely industrial concerns, a total of 20·84 lakhs up to 7 February 1925, were:—
Indian concerns ... 13·14 lakhs or 63 per cent
European concerns ... 7·7 ,, or 37 ,,

12. Its position in recent years in respect of deposits and cash balances is clearly brought out by the table given overleaf.

[1] These figures are included in the totals of 'Deposits' and 'Advances' in the preceding tables.

	Total deposits (public and private)	Cash balances	Proportion per cent of cash to liabilities on deposits
	(Rs. 1,000)		
	Presidency banks		
31 Dec. 1905	25,38,28	8,23,01	32
,, 1910	36,58,01	11,35,12	31
,, 1913	42,37,16	15,37,75	36
,, 1914	45,65,60	20,83,92	46
,, 1915	43,49,86	14,65,24	34
,, 1916	49,91,45	17,27,25	35
,, 1917	75,43,02	33,77,31	45
,, 1918	59,62,03	17,07,62	29
,, 1919	75,93,61	23,62,93	31
,, 1920	87,04,53	26,03,34	30
	Imperial Bank		
,, 1921	72,58,00	13,60,23	19
,, 1922	71,16,30	15,07,47	21
,, 1923	82,76,45	15,01,34	18
,, 1924	84,21,48	15,60,26	18
,, 1925	83,29,77	17,46,82	21
,, 1926	80,35,06	20,90,10	26
,, 1927	79,27,45	10,88,65	14
,, 1928	79,25,30	10,57,58	13
,, 1929	79,24,28	13,99,85	18

These figures are not at all encouraging reading. In 1915 the total amount of private deposits was only 38.61 crores; at the end of the next five years, in 1920, they increased to 78.01 crores; during the succeeding nine years, these deposits, instead of increasing at the normal rate, actually *declined,* the fall in the first two years after the amalgamation of the presidency banks being as heavy as 21 crores. Much more serious than this is the deterioration in the cash

position, the proportion per cent of cash to liabilities on deposits having declined from 45 per cent in 1917 and 30 per cent in 1920, to 18 per cent in 1923 and 1924, 14 per cent in 1927 and 13 per cent in 1928. The position in this respect improved slightly in 1929, the percentage of cash to liabilities in that year being 18 per cent, but it fell again to 14.35 per cent in December 1930, 11.58 per cent in February 1931, 13.58 per cent on 22 January 1932, and 12.33 per cent on 11 March 1932.[1] As a bankers' bank, the cash position of the Imperial Bank should have been much stronger and not weaker than that of the old independent presidency banks.[2] With the increase of a hundred new branches, the responsibilities of the Imperial Bank with regard to the sufficiency of cash balances are far greater than those of the presidency banks during 1913-20. It is clear that the authorities in charge of the bank's affairs do not seem to realize adequately the responsibilities attached to the bankers' bank in a country like India.

13. The statement given on the next page shows the Imperial Bank's rates, the call-money rate and the bazaar bill rates on the first day of each month of the year 1930-1. It should be noted that the bank rate in India means something quite different from the bank rates of the central banks of other countries. Whereas the latter usually denote the rates at which first class trade bills can be discounted at the central bank, the former is the rate at which the Imperial Bank is prepared to grant demand loans against *Government securities*. The Imperial Bank's *hundi* rate is, on the other hand, the rate at which it will discount or rediscount first class three months' bills. The call-money rate is the rate for surplus money seeking employment for possibly a minimum period

[1] See *Indian Finance*, 30 January, 19 March 1932.

[2] The Bank of England in pre-War days kept as much as fifty per cent of its liabilities in reserve (see *Hilton Young Commission Report*, Minutes of Evidence, Q. 5323).

of twenty-four hours, whereas the bank rate indicates the charge for the use of money for a specified period. Moreover, call-money is repayable at the option of either the lender or the borrower, while advances against securities at bank rate are usually repayable at the option of the borrower only.[1] The bazaar rates shown in this statement are those at which the bills of *small* traders are discounted by shroffs, the rates for bills of large traders not being given separately as they follow closely the Imperial Bank hundi rate.[2]

Indian money rates (monthly)

Date	Bank rate	Call-money rate		Imperial Bank hundi rate	Bazaar bill rate	
		Calcutta	Bombay		Calcutta	Bombay
1930			(per cent)			
1 April ...	6	5	6	6	11	$7\frac{9}{16}$
1 May ...	6	$4\frac{1}{2}$-$4\frac{3}{4}$	5	6	10-11	$7\frac{15}{16}$
1 June ...	6	$4\frac{1}{2}$	5	6	10	$8\frac{5}{16}$*
1 July ...	6	$4\frac{1}{2}$	5	6	8-9	$8\frac{5}{16}$
1 August ...	5	$2\frac{1}{2}$	$2\frac{1}{2}$	5	7-8	$8\frac{5}{16}$
1 September ...	5	$1\frac{3}{4}$	2	5	7-8	$8\frac{5}{16}$
1 October ...	5	$2\frac{1}{2}$	$2\frac{1}{4}$	5	7-8	$6\frac{3}{8}$
1 November ...	5	$2\frac{1}{4}$	2	5	7-8	$6\frac{3}{8}$
1 December ...	6	2	$2\frac{1}{4}$	6	7-8	$6\frac{3}{8}$
1931						
1 January ...	6	3	3	6*	7-8	$6\frac{3}{8}$*
1 February ...	7	$3\frac{1}{2}$-4	$5\frac{1}{2}$	7*	7-8	$6\frac{3}{8}$*
1 March ...	7	$4\frac{1}{2}$-5	$5\frac{3}{4}$	7*	9-10	$7\frac{9}{16}$*

14. Besides the three main constituent members of organized banking in India, there are savings banks opened by Government at their post offices. Government maintain no specific reserves against

[1] *Indian Central Banking Inquiry Committee Report*, para. 580.
[2] See *Report of the Controller of Currency* (1930-1), para. 30.
* On the 2nd of the month.

the deposits received at these savings banks, their general balances being considered as a sufficient security against a run on them, but in view of the rapid growth in the amount of these deposits as well as in the number of depositors who hold them, such a practice cannot be considered as quite safe in a country where banking is of comparatively recent growth and where confidence in a foreign Government can be rudely shaken on a sudden alarm. The table shown below sets out the progress of these savings banks.

Year	Number of banks	Number of depositors	Deposits each year (inclusive of interest)	Withdrawals each year	Balance of deposits (inclusive of interest)	Interest
		(1,000)	(thousands of rupees)			
1899-1900	...	786	3,75,97	3,54,13	9,64,64	28,27
1909-10	...	1,379	6,00,21	5,36,90	15,86,72	44,77
1913-4	9,824	1,639	11,60,37	9,04,76	23,16,75	61,91
1917-8	10,975	1,638	10,16,69	10,17,76	16,58,46	44,40
1920-1	10,713	1,878	18,84,85	17,33,48	22,86,22	62,20
1925-6	11,162	2,317	19,78,68	18,19,48	27,23,15	73,99
1926-7	11,994	2,518	21,17,02	18,89,27	29,50,99	79,21

15. Since the Co-operative Credit Societies Act of 1904, considerable progress has been made in India by co-operative credit banks also. They were established primarily with a view to financing the Indian cultivator, and though at the present time a number of co-operative credit societies exist in the urban areas also, the co-operative credit movement is, on the whole, a rural rather than an urban achievement. The co-operative credit banks are of three grades, namely (1) primary societies of a number of people residing in a locality and joined together on the principle of limited or unlimited liability for one another's obligations; (2) district co-operative societies formed by a union of primary societies on a co-operative basis; (3) central co-operative societies.

formed by a combination of district co-operative societies. In some of the provinces there is in addition to these three, an apex provincial bank organized on the same principles. These various classes of co-operative credit societies receive deposits and raise loans which they utilize in advancing money to their own members in proportion to their worth and needs. The progress of this co-operative credit movement has been phenomenally rapid in recent years. In 1917 the number of the co-operative societies was only 24,393 with a membership of 1,048,290 persons; the total amount of money borrowed by them from private persons, other societies and banks was Rs. 9,13,66,692; the deposits received by them from their own members amounted to Rs. 79,99,999; and the loans issued by them to members and other societies aggregated to Rs. 6,77,41,199. In 1926-7 the number of societies rose to 76,371 and that of their members to 3,195,478; the loans from private persons, other societies and banks increased to Rs. 44,50,76,190; deposits jumped up to Rs. 4,20,88,260; and the loans issued to members and other societies amounted to Rs. 38,26,50,497. The tables overleaf give detailed information regarding the principal co-operative banks at the end of each year from 1918-9 to 1929-30.

16. We are now in a position to note the main deficiencies in the Indian system of banking. The indegenous bankers or the town shroffs have lost all contact with the agriculturists even though some of them are willing to lend at rates of interest below six per cent in the season when the agricultural industry needs financing. On the whole, there is insufficiency of banking funds with them; they have very few deposits and keep no reserve against them; they make sparing use of the *muddati* hundi for raising funds because of the high stamp duty; they lend against promissory notes or running accounts, neither of

Class A—Banks with capital and reserve of five lakhs of rupees and over

Year	Number of banks	Paid up capital	Reserve	Total	Deposits and loans received	Loans outstanding	Cash balances
		(thousands of rupees)					
1918-9	4	19,99	4,68	24,67	1,35,44	1,11,09	7,36
1919-20	2	10,34	4,08	14,42	96,34	86,93	4,10
1920-1	5	28,15	8,41	36,56	2,29,38	2,31,59	3,83
1921-2	5	29,80	9,96	39,76	2,82,68	2,59,30	22,89
1922-3	5	30,68	12,92	43,60	3,41,05	2,57,48	47,71
1923-4	8	44,36	17,99	62,35	4,13,99	3,32,89	37,13
1924-5	8	47,53	21,73	69,26	4,51,41	3,53,81	19,08
1925-6	10	60,37	30,25	90,62	5,37,83	4,46,18	26,55
1926-7	12	76,95	35,59	1,12,54	7,00,65	5,18,13	13,29
1927-8	16	1,03,46	46,36	1,49,82	8,83,56	6,62,29	68,31
1928-9	18	1,16,99	46,35	1,63,34	9,01,49	6,80,29	77,76
1929-30	22	1,39,76	64,94	2,04,70	10,90,16	8,92,66	84,66

Class B—Banks with capital and reserve of over one lakh and less than five lakhs of rupees

Year	Number of banks	Paid up capital	Reserve	Total	Deposits and loans received	Loans outstanding	Cash balances
		(thousands of rupees)					
1918-9	29	31,78	8,82	40,60	1,57,37	1,73,73	7,12
1919-20	29	48,96	15,12	64,08	2,63,79	2,83,92	7,17
1920-1	36	55,73	14,22	69,95	2,48,90	2,77,38	12,87
1921-2	46	77,29	16,75	94,04	3,63,00	3,78,38	16,24
1922-3	63	1,01,63	29,42	1,31,05	5,02,02	5,18,84	15,08
1923-4	72	1,17,11	55,52	1,72,63	5,87,52	6,44,93	25,41
1924-5	93	1,20,93	49,30	1,70,23	8,03,76	7,72,43	40,51
1925-6	104	1,46,43	56,41	2,02,84	9,29,81	8,79,51	62,52
1926-7	119	1,53,49	71,25	2,24,74	11,97,69	11,27,83	73,14
1927-8	125	1,61,56	86,94	2,47,34	13,16,36	11,97,99	79,82
1928-9	141	1,79,89	98,32	2,78,21	14,99,42	13,20,30	72,20
1929-30	157	1,95,78	1,12,27	3,08,05	16,12,78	14,12,10	67,67

which can be rediscounted by them. They generally distrust the Imperial Bank because it competes with them and competes in their opinion unfairly by means of free funds from Government. There is no effective

contact between them and the Imperial Bank with the result that the Imperial Bank's bank rate is ineffective and while there is some feeling of mutual help among the members of the same caste in some centres, there are very few associations of indegenous bankers to keep up the standard of banking for the furtherance of their common interests.[1]

As regards joint stock banks, a few figures are enough to prove that in spite of the progress made in recent years India is still very backward in respect of modern banking facilities. In the United Kingdom there is on an average one banking office to every thirteen square miles, against one to every 3,532 square miles in India.[2] Out of 2,300 towns in India only 185 had a bank, or a branch or agency of a bank, in the year 1919, while in 1928 the number of such towns was only 339.[3] About 20 per cent of the Indian towns with a population of more than 50,000 are without a bank at all and nearly 75 per cent of those with a population of between 10,000 and 50,000 are in the same category.[4] Totalling up the private deposits in the Imperial Bank (71 crores), the Indian deposits of 18 exchange banks (71 crores), the deposits of 74 Indian joint stock banks (66 crores), of post office savings banks (34 crores), and of the Indian central and provincial co-operative banks (21 crores), the aggregate in 1928-9 comes to only Rs. 267 crores for a population of 35 crores. This works out at Rs. 7.6 per head of the population. It is impossible to have any efficient system of banking with such small deposits. Poverty of the people is not an adequate explanation of these low deposits, for the net imports of treasure into India amounted on an average to as much as 36.07 crores a year during the five pre-War years ending 1913-4,

[1] *Central Areas Banking Inquiry Committee Report*, para. 217.
[2] Thakur, B. T., *Organization of Indian Banking*, p. 82.
[3] *Indian Central Banking Inquiry Committee Report*, para. 538.
[4] Excluding co-operative societies (M. L. Tannan's presidential address, Indian Economic Conference, Calcutta, 1927).

to 10.8 crores a year during the five War years ending 1918-9, to 39.53 crores a year during the seven years ending 1925-6, to 39.33 crores in 1926-7, 32.19 crores in 1927-8, 52.11 crores in 1928-9, 52.78 crores in 1929-30, and 37.55 crores in 1930-1.[1] The total amount of treasure hoarded in India has been variously estimated; a recent estimate puts it at one thousand million pounds sterling.[2] In other words, for every seven rupees deposited in banks, about forty-two are hoarded. An essential condition to any real advance in banking is a radical change in this uneconomic habit of hoarding.

Such joint stock banks as exist are again of very small size as compared with those of other countries. An experienced Indian banker has pointed out that the deposits of each of the 'big five' of London are more than the total Indian deposits; that the deposits of the Imperial Bank of India, which has the largest deposits in this country, are less than one-third of the deposits of the National Provincial Bank, which has the smallest deposits amongst the big five in London; and that the deposits of the Allahabad Bank, the oldest of the Indian joint stock banks, are less than one-twenty-eighth of the deposits of the same English joint stock bank.[3]

Nor have we the rich variety of banks which exists in other countries. Our banks deal only in short-term credit. We have no industrial banks and land mortgage banks which would give long-term credit to industry and agriculture. Apart from post offices, we have no municipal and local savings banks. Apart from exchange banks, which are really foreign, we have no banks which deal in foreign exchanges on any appreciable scale.

[1] See *Report of the Controller of Currency* (1930-1), statement 2.

[2] See Mr. E. L. Price's speech at the Royal Society of Arts in 1928; Sir James Wilson estimates the imports of gold alone since 1835 at 450 million pounds; according to Mr. Joseph Kitchin India has absorbed since 1443 approximately 553 million pounds' worth of *gold* alone.

[3] Thakur, B. T., *Organization of Indian Banking*, p. 90.

Our branch banking is yet in its infancy. It is, moreover, not designed to bring capital where it is really scarce; its extension is rather a curse in rural areas, for its activities in the mofussil are directed, not to the employment of funds in agriculture or trade, but to the purpose of securing deposits for use at the presidency towns and the larger commercial centres. The function of supplying local needs is left entirely to the private banker with the result that high rates of interest often prevail in the Indian mofussil bazaar.[1]

Another most serious deficiency in our banking organization is the absence of a true central bank and of a real bill market. The Imperial Bank is not yet a note-issuing authority, with the result that there is no co-ordination between our currency reserves and banking reserves and no appreciable relief from the inconvenience caused by wide fluctuations in the bank rate.[2] It is even now mainly a commercial bank, dealing directly with the public and competing with other banks, and cannot on that account be a real bankers' bank, holding the bulk of the reserves of the other banks and branches of banks in the country. Even the banking reserves of India are thus not centralized. At the present time the Imperial Bank is not even Government's bank in the full sense of the term, the paper currency, the Gold Standard Reserve and remittances to England being still managed directly by Government. Unlike the central banks in other countries, it continues to receive deposits from private persons and to pay interest to them, so that it is not free from that pressure to lend that the custody of private accounts

[1] Gubbay, M. M. S., *Indigenous Banking in India*, pp. 6-8.

[2] See in this connexion *Hilton Young Commission Report*, vol. II, pp. 60-3, Appendix to Mr. Denning's Memorandum on the transfer of the management of the paper currency to the Imperial Bank of India, in which it is shown how the rates could have been kept under control between the end of October 1923 and the end of September 1925 if both our currency and banking reserves had been under one management.

inevitably brings in its train.[1] With divided responsibility and multiple reserve system, with pressure from its shareholders for fat dividends on the one hand and from its private depositors and clients for accommodation on the other hand, the Imperial Bank is not in a position to act as the real custodian of the interests of Indian banking as a whole. Nor is it in a position to control effectively the credit situation in the country, for the banking system is loosely organized and there is nothing like a real bill market in the country. There is no regular connexion between the indegenous bankers and the rural money-lenders, nor does any close connexion exist between the Imperial Bank of India and the joint stock banks.[2] Both the indegenous bankers and the Indian joint stock banks look upon the Imperial Bank and the exchange banks as unfair rivals rather than as friendly coadjutors.[3] The banks lend money by granting cash credits or running overdrafts, the amount of which will vary from day to day, and not by re-discounting bills and, unlike the case in other countries, do not encourage the habit of drawing bills by making their discount rates very much lower than the rates for cash credits. We have no accepting houses such as exist in London and our Indian shroff mainly uses his own funds in his hundi business and ordinarily does not re-discount them. In the absence of a true central bank, prepared *at all times* to re-discount *good* bills, neither are the joint stock banks always ready to lend on or discount bills, nor are the Indian shroffs tempted to extend their business in hundis beyond their own financial resources in the hope of being able to re-discount such of them as conform to banking rules with either the ordinary banks or, as a last resort, a central bank.[4] As has already

[1] Kisch, C. H., and Elkin, W. A., *Central Banks*, p. 105.
[2] *Indian Central Banking Inquiry Committee Report*, para. 573.
[3] Ibid., loc. cit.
[4] Mr. M. M. S. Gubbay's cross-examination on this point: 'But is not a central bank's power to discount or re-discount bills fundamental

been noticed, the operations of the Indian shroff are at present very little affected by the credit policy of the banks, except at times of temporary stringency or pressure, when the supply of hundis in the market exceeds the capacity of the Indian shroffs to finance them. Unless the Indian shroffs, and through them the other indigenous private bankers, are brought within the influence and reach of a true central bank, the credit situation cannot be brought under the control of a single authority. Moreover, a bill market is essential for what is technically known as the 'open market operations' of a central bank. Experience has shown that the quickest method by which a central bank can of its own motion relieve monetary stringency is to *purchase* in the market *bills* or securities, and that at times the most effective way in which it can contract currency is to *sell* in the open market bills or securities. A central bank and a bill market are each complementary to the other. Unfortunately, India has neither. Consequently she lacks the two most essential requirements of a modern banking organization, namely the centralization of reserves and the mobility of credit through the bill of exchange.

One of the most serious consequences of this state of affairs is the independence of the various money-markets in India. There is firstly the Indian money-market or the bazaar, and secondly the market controlled by banking institutions on western lines. The bazaar rates for small traders' bills in Bombay have often no connexion with the Imperial Bank rate and the former differ greatly from those prevailing in the Calcutta bazaar. In Bombay city alone there are the Gujarati, the marwari and the multani bazaars with their different rates; and there is an

to the establishment of a discount market? Is it not a fact that the discount markets in all the great financial centres rest really upon the possibility of re-discounting with a central bank?—I agree that is so.—*Hilton Young Commission Report,* Minutes of Evidence, Q. 12374.

extraordinary sluggishness in the movement of credit between the various markets with the result that a call rate of $\frac{3}{4}$ per cent, a bank rate of 4 per cent, a Bombay bazaar rate for bills of small traders of $6\frac{3}{4}$ per cent and a Calcutta bazaar rate for bills of small traders of 10 per cent can exist simultaneously in India.[1]

17. With a view to removing some at least of these deficiencies, the Hilton Young Commission emphasized the urgent need of establishing in India a central bank modelled on the lines which experience in other countries had shown to be sound. They rightly pointed out that the foundation of credit organization in India will not be truly laid until, through the facilities of re-discounting which a central bank affords, the commercial bill, the most legitimate asset of commercial banks, becomes a quick asset capable of prompt realization in times of stress.[2] They ruled out the proposal to transform the Imperial Bank into a central bank for India on the ground that the restrictions on business properly imposed on central banks in other countries would, in the case of the Imperial Bank, 'preclude it from undertaking a great many tasks which it now successfully performs as a commercial bank' with the unfortunate result that 'the country would then lose the benefit of the elaborate and the widespread organization which has been set up, through the length and breadth of India, to make available to the community the increased commercial banking facilities, which are so urgently needed, and to assist in fostering, among the people as a whole, the habit of banking and investment'.[3] They recommended instead the setting up of an entirely new reserve bank for India with functions similar to those of the central banks in other countries. It should have

[1] *Indian Central Banking Inquiry Committee Report*, para. 579.
[2] *Hilton Young Commission Report*, para. 83.
[3] Ibid., para. 87.

the sole right of note-issue and the responsibility of maintaining the stability of the currency. It should be the custodian of the currency and banking reserves of the country and of the cash balances of the Government. Its business, in the main, should be confined to that of a bank of the banks and of the Government. It should be prevented from transacting the everyday commercial business of the country or from entering into competition with the commercial banks in any general sense, but in times of crisis it should intervene vigorously in the country's business by extending credit facilities liberally. It should be primarily concerned with upholding the credit of the country and guiding its financial policy.

The Commissioners endorsed the resolutions passed by both the International Financial Conference of Brussels (1920) and that of Genoa (1922) recommending in identical terms that 'banks, and especially banks of issue, should be free from political pressure, and should be conducted solely on lines of prudent finance'. In the spirit of these resolutions they recommended that the central board of the proposed reserve bank should be composed of fourteen members, of whom nine should be elected by shareholders, and a maximum of three should be nominated by the Governor-General-in-Council in addition to a managing governor and deputy managing governor also nominated by the Governor-General-in-Council. Government should be entitled to nominate also to the board an official member who should have the right and duty to attend and advise the board but not to vote. Apart from this central authority, the Commission recommended the formation of local boards consisting mainly of the representatives of the shareholders registered in the respective branch registers. In order to eliminate the danger of political pressure being exercised upon the boards of the reserve bank, it was suggested that a provision be introduced in its charter directing

that no person should be appointed president or vice-president of a local board or be nominated as a member of the central board, if he were a member of the Governor-General's Council, the Council of State, the Legislative Assembly or any of the Provincial Governments or Legislative Councils,[1] and as the reserve bank's principal function would be to re-discount bankable bills held by the commercial banks, the Commission thought it undesirable to allow a representative of any of the commercial banks to hold the position of president, vice-president or member of a local board or the central board.[2]

The Government of India accepted these recommendations of the Commission and incorporated them in a Bill, to establish a gold standard currency for British India and constitute a Reserve Bank of India, which was published on 16 January 1927. The attempt to get it through the Legislature, however, met with unexpectedly strong opposition. All important sections of public opinion in India recognized the need of a central bank in India; there was a general agreement over most of the main principles of the Bill; and yet the Bill was wrecked in the whirlpool of politics. The Bill, as introduced into the Legislative Assembly in January 1927, followed the suggestion made in the report that the central governing board of the reserve bank should consist of fifteen members including one Government official who should not have a vote. Of the remaining fourteen members, five including the governor and deputy governor were to be nominated by the Government of India and nine were to be elected by the shareholders, since the capital of the bank was to be share capital. The Bill was referred to a Joint Select Committee of the Council of State and the Legislative Assembly, the majority of whom disagreed with the proposals in two main particulars.

[1] *Hilton Young Commission Report*, para. 95.
[2] Ibid., para. 96.

They desired to introduce a gold coin into the currency and they preferred a State bank rather than a shareholders' bank. As to the composition of the central board, they proposed that only four of the directors, including the governor and the deputy governor, should be nominated by the Government of India, that three each should be chosen by the elected members of the Central Legislature and the Provincial Legislatures respectively, two each be elected by the Federation of Indian Chambers of Commerce and the Associated Chambers of Commerce, while the last place was to be filled by election by the provincial co-operative banks. Accordingly, these proposals were incorporated in the Bill which was brought before the Assembly on 29 August. During the course of the debate, when agreement seemed otherwise impossible, Sir Basil Blackett in a spirit of compromise took up the suggestion made in an amendment, tabled by Mr. Srinivasa Iyengar, to replace the shareholders as electors by a system of electoral colleges and outlined a scheme generally known as the 'Stock-holders' Scheme', according to which the reserve bank was to be a State bank with all its capital owned by Government. The necessary capital was to be raised in the market by issuing at par stock bearing five per cent interest in amounts of one hundred and multiples thereof. No stock-holder was to hold more than a thousand rupees' worth of stock and all stock-holders had to be either domiciled or ordinarily resident in India. A register of stock-holders was to be kept in each of the major provinces in India and in Delhi, and provided there were at least a thousand stock-holders on the register, these were to be allowed to elect sixty trustees triennially, who were in turn to elect one director of the bank. Each stock-holder was to have only one vote for the election of trustees, no matter what the amount of his holding might be. The constitution of the governing board of

the bank was to be as follows :—one governor and two deputy governors, one not voting; three directors elected by the Associated Chambers of Commerce, one director elected by the provincial co-operative banks, ten by the trustees, elected as described above, and four nominated by the Governor-General-in-Council. Although it was evident that this scheme was likely to be acceptable to the majority of the members of the Assembly, the Government of India postponed the consideration of the whole question in view of its divergence from the original Bill submitted to the Assembly. During the interval between the Simla Session of 1927 and the Delhi Session of 1928, Government decided to come forward with a new Gold Standard and Reserve Bank Bill which reverted to the shareholders' principle but retained many of the features of Sir Basil Blackett's suggested compromise. It allotted specified shares to Bombay, Calcutta, Madras, Rangoon and Delhi and proposed such qualifications for shareholders as to ensure a predominant share of the capital being held by persons and companies domiciled in India or registered by Acts of Parliament, and scheduled banks which were required to maintain certain minimum reserves with the bank. Members of the Legislatures were prohibited from being directors and the central board was proposed to be constituted as follows :—(i) a governor and deputy governor to be nominated by the Governor-General-in-Council on the recommendation of the board; (ii) four directors to be nominated by Government; (iii) two each to be elected by the Associated Chambers of Commerce and the Federation of the Indian Chambers of Commerce; (iv) one to be elected by the provincial co-operative banks; (v) one officer to be nominated by the Governor-General-in-Council; and (vi) eleven directors to be elected by elected delegates of the shareholders on the various registers. The new Bill was stillborn. The President

of the Assembly refused his sanction to its introduction on the ground that the procedure of the House of Commons required that, when essential alterations were made in any Bill which had come before the house, the proper course was to ask leave to withdraw the original Bill and resubmit it as altered. Government were therefore obliged to proceed with the old Bill, but the feeling against that Bill was found to be too strong in the Assembly and after a number of divisions on the amendments to one of the clauses had been won by Government, the motion that the clause stand part of the Bill was lost in a division. Neither side was able to have its way and the Bill threatened to assume a form for which neither the Government nor the opposition would have cared to assume any responsibility. Government therefore announced that they had no intention of proceeding with the Bill in view of the attitude taken up by the House. The reserve bank and with it the entire scheme for the permanent reorganization of the Indian currency system were thus postponed *sine die*.

18. In 1929 and 1930, the entire subject of credit and banking conditions in India came under the searching examination of the Provincial and the Central Banking Inquiry Committees. The chronic indebtedness of the agriculturist was one of the problems investigated by these committees and the conclusion reached was that the discovery of a remedy for the present situation was of supreme importance. The Indian Central Banking Inquiry Committee therefore recommend that the Local Governments should pursue a vigorous policy of debt conciliation on a *voluntary* basis[1] and explore the possibility and desirability of undertaking other legislation to secure the settlement of debts on a compulsory basis.[2] They suggest that the case for a simple rural

[1] *Indian Central Banking Inquiry Committee Report*, para. 91.
[2] Ibid., para. 94.

Insolvency Act should be considered in every province,[1] and commend to the Local Governments legislation on the general lines of the Punjab Regulation of Accounts Act 1930, providing for the money-lender's invariably granting receipts for all repayments made by the borrower and maintaining counterfoils thereof.[2] They comment on the limited facilities available to the agriculturist for redeeming his standing debts and are in favour of encouraging the establishment of co-operative land mortgage banks where there are reasonable prospects of their working successfully, having regard to all the local conditions.[3] But in order to satisfy the credit requirements of the large class of agriculturists who are outside the co-operative movement and to provide for substantial loans to big landlords, provincial land mortgage corporations on a joint stock basis, or on the model of the English Land Mortgage Corporation would, in their opinion, be necessary.[4] In order to ensure the successful working of these land mortgage banks, they recommend that the land mortgage banks should be given the power of foreclosure and sale without recourse to civil courts, subject to certain safeguards, that the existing insolvency law be amended so as to give greater protection to the land mortgage banks, and that the Land Alienation Acts be altered so as to give *co-operative* land mortgage banks the right to take possession of land through foreclosure on default of the payment of the instalment of the loan, and to sell it.[5]

The report emphasizes the importance of indigenous bankers, and with a view to encouraging them, recommends that such of the indigenous bankers *as are engaged in banking proper* should be eligible to

[1] Op. cit., para. 93.
[2] Ibid., para. 116.
[3] Ibid., para. 87.
[4] Ibid., para. 87.
[5] Ibid., paras. 225-8.

be placed on the approved list of the future reserve bank in the same manner as joint stock banks,[1] without being compelled to keep certain interest-free balances with the reserve bank during the first five years if their deposits do not exceed five times their capital.[2] They are to be given facilities for remittance of funds at the same rates as are charged to all joint stock banks. These privileged indigenous bankers will be required to have proper books of account kept in the usual recognized manner, and to have them audited annually by recognized auditors.

The Committee's detailed recommendations regarding co-operative banking are intended generally to remove the defects in the existing organization of the co-operative movement. From the point of view of principles, the most important of their recommendations is that the ordinary co-operative credit societies should confine themselves to dispensing short-term and intermediate credit, long-term credit being provided only by land mortgage banks.[3] The claims of co-operative banks for specially favourable treatment at the hands of the Imperial Bank are recognized by the Committee, and special emphasis is laid on the importance of (1) cash credit and overdraft facilities being generously given by the Imperial Bank on proper co-operative paper satisfying the standards prescribed by the bank,[4] (2) the removal of difficulties on the free remittance of funds for co-operative purposes, and (3) placing the co-operative banks on a footing of equality with the joint stock banks as regards remittance facilities for other than co-operative purposes.[5] Further, the co-operative banks are, under their recommendations, to be linked with the reserve bank, when it is

[1] Op. cit., para. 139.
[2] Ibid., para. 140.
[3] Ibid., para. 165.
[4] Ibid., para. 181.
[5] Ibid., para. 182.

established, and with a view to securing this, they recommend that :—

'(i) The provincial co-operative banks should, along with joint stock banks be included in the list of member banks and entitled to re-discount facilities from the reserve bank.

'(ii) The reserve bank should be authorized to re-discount agricultural bills drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and in order to meet the special conditions of agriculture in India these bills be such as mature within nine months from the date of their re-discount by the reserve bank.

'(iii) Although in the interests of the liquidity of the reserve bank's assets, it should be necessary to prescribe a maximum limit for the amount of agricultural bills re-discounted by the reserve bank, the fixation of the limit should take into account the requirements of agriculture and avoid the danger of making the provision nugatory.

'(iv) The reserve bank should also be authorized to make loans and advances repayable on demand or on the expiry of a fixed period not exceeding ninety days on the security of agricultural paper endorsed by the provincial bank.

'(v) The reserve bank should be given power to make loans and advances on the security of movable goods, wares and merchandise, besides warehouse warrants or warehouse receipts representing the same.'[1]

Dealing with the question of finance for industry, the Committee express the opinion that 'in connexion with the issue of shares and debentures by industrial companies, such of the existing commercial banks as are well-established and carry on their ordinary banking business on the safest and soundest lines, might with advantage to the industries follow,

[1] Op. cit., para. 191.

as far as possible, the German system',[1] under which 'banks in Germany have played an important part in providing the greater part of the initial capital, which is subsequently placed among the investing public either by offering it for public subscription or by direct sale to customers or to banking firms having relations with the banks'.[2] Recognizing, however, that the bulk of the joint stock banks in India are not at present ready for this activity, the Committee recommend that 'if a Provincial Government in the discharge of their responsibility for the development of industries within their territories find it necessary to ensure the supply of financial facilities to industrial concerns, a provincial industrial corporation with branches, if necessary, and working with capital initially or permanently supplied by the Provincial Government should be established'.[3] An effort is to be made to raise the necessary share capital as far as possible from the public, but in view of the obvious limitations in the present circumstances of India, the Committee consider it necessary that Government should take up such portion of the share capital of the corporation as cannot be raised by public subscription. The share capital is to be supplemented by debenture capital not exceeding twice the amount of the share capital, Government purchasing a portion of the debentures until a regular market for them has been created.[4] Additional resources may be secured by the industrial corporation taking long-term deposits from the public, but an immediate beginning with deposits for less than two years is considered undesirable. This industrial corporation is to specialize in the provision of long-term capital to industries, which will continue to obtain their working capital from existing institutions.[5]

[1] Op. cit., para. 391.
[2] Ibid., para. 387.
[3] Ibid., para. 391.
[4] Ibid., paras. 403-404.
[5] Ibid., para. 406.

As regards the financing of foreign trade, the majority of the Committee conclude that though 'the facilities available at present for financing India's foreign trade, both imports and exports, are sufficient',[1] 'it is not desirable that India should rely for all time on the facilities afforded by non-Indian institutions for the financing of her foreign trade'.[2] They therefore suggest that such of the Indian joint stock banks as are well-established should open foreign connexions useful to their clients[3] and that on the establishment of the reserve bank and the simultaneous withdrawal of the restrictions now imposed on the transaction of foreign exchange business by the Imperial Bank of India, the latter should be induced to take an active share in the financing of India's foreign trade and to agree, in return for concessions from the reserve bank, to seventy-five per cent of the directors on its local boards and a majority of those on its central board being Indians and to no further recruitment of non-Indians to its staff except in special cases and with the approval of the Finance Minister of the Government of India.[4] Should the latter suggestion for any reason prove impracticable, Government should take steps, in consultation with the reserve bank, to inaugurate a new Indian exchange bank.[5] The subscription to the share capital of the new bank should, in the first instance, be open to joint stock banks registered in India, and in case the share capital be not fully subscribed within the prescribed time limit, the balance should be supplied by Government, who would gradually arrange to dispose of their holding later on to the general public. Further details of the scheme should be worked out by the reserve bank

[1] Op. cit., 477.
[2] Ibid., para. 481.
[3] Ibid., para. 482.
[4] Ibid., para. 483.
[5] Ibid., para. 485.

when the occasion for establishing the suggested exchange bank arises.

Among the other recommendations of the Indian Central Banking Inquiry Committee, the most important relate to the creation of a central or reserve bank and an adequate bill market in India. The establishment of the former at the *earliest possible date* is considered to be a matter of supreme importance from the point of view of the development of banking facilities in India and of her economic advancement generally, for it will, by centralizing the banking and currency reserves of India, tend to increase the volume of credit available for trade, industry and agriculture and to mitigate the evils of fluctuating and high charges for the use of such credit by keeping sufficient free resources at the beginning of the busy season to supply the additional currency needed during the crop-moving season.[1] The details of the constitution of the proposed reserve bank are outside the terms of reference of the Committee, but in order to arrive at a basis on which their recommendations regarding the working of the reserve bank and its relations with the money-market should be formulated, the Committee agree to proceed on the assumption that (1) the reserve bank will be established by an Act of the Indian Legislature; (2) the capital of the bank will be provided by the State; (3) the bank will be under Indian control; and (4) the bank will be free from interference from Governments or Legislatures (Indian or British) in its day-to-day administration. On the advice of foreign experts, the Committee suggest a few important changes in the provision of the Reserve Bank Bill of 1928. With a view to enabling the reserve bank to operate with effect in the open market and make its policy effective, the Committee recommend that additional provision should be made in the Reserve Bank Bill enabling

[1] Op. cit., paras. 587, 605.

the bank to make loans and advances on the security of movable goods, wares, and merchandise, as well as against the warehouse warrants or warehouse receipts representing such goods. This does not mean that the reserve bank should ordinarily compete with commercial banks for profit; it is intended to be merely a reserve power to be exercised in emergencies. Very likely, it will seldom be availed of, for the mere fact of its existence will enhance the influence of the reserve bank on the level of interest rates. The second important amendment suggested is that the powers of the reserve bank to purchase, sell, and re-discount bills and promissory notes should not be restricted to only those drawn and payable in India but should be widened so as to embrace rupee import bills. The Committee further recommend that if the limit in the Reserve Bank Bill for the holding of agricultural bills of maturity longer than three months is at any time less than the share capital of the bank, the total face value of such bills may, at the discretion of the bank, go up to the amount of the share capital. Among the other changes suggested in the Reserve Bank Bill the following are worth mentioning :—

(1) The period of six months for agricultural bills may be extended to nine months to suit the conditions of agriculture in India.

(2) The reserve bank should be permitted to act as an agent for any Indian State that may desire to utilize its services.

(3) The limit of the powers of the reserve bank to borrow money should not be limited to the amount of the share capital but should be extended to the share and the reserve fund of the bank.

With a view to developing the bill market in India, the Hilton Young Commission recommended the abolition of the stamp duty on bills of exchange. The Indian Central Banking Inquiry Committee repeat that recommendation with the further

suggestion that it should be given effect to within a period of five years and that as an initial step the stamp duty on all bills of less than one year's usance should be reduced to a uniform rate of two annas per two thousand rupees.

It will thus be seen that the recommendations of the Committee cover a wide field and will, if carried out, involve far-reaching changes in the general structure of the banking system and the money-market in India.

ERRATA

p. 51, line 19. *For* B has to send to it *read* it has to send o B

p. 71, line 14. *For* changes *read* exchanges.

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